Chapter

2 Developments at the World Bank

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The 1980s were a difficult time for many member countries of the World Bank. In response, the Bank developed two new programs for helping its members cope with economic problems: structural adjustment lending and debt reduction. The two programs are closely related.

Structural Adjustment Lending

The new programs mark a shift away from the traditional project orientation of Bank lending. By 1989, adjustment lending accounted for about 30 percent of Bank and International Development Association (IDA) lending. In Latin America, adjustment lending was 43 percent of the total. Such lending is an important and growing aspect of Bank work. Therefore, this paper will first describe these programs and their legal basis and then address specific elements of the programs.

The Articles of Agreement of the World Bank and the International Monetary Fund were negotiated during the Second World War at a conference held at Bretton Woods, in New Hampshire. The Bretton Woods institutions were designed to prevent the international economic disasters of the 1930s from recurring in the postwar period. The economic catastrophe of the 1930s had left most of the world's economies in shambles and international trade down sharply. Moreover, by the end of 1938, more than 40 percent of outstanding dollar bonds issued by national governments (other than the United States) were in default.

Drafters of the Bank's Articles of Agreement incorporated various orders of prudence, based largely on lessons learned from the collapse of international credit in the 1930s. Loans were to be made for productive purposes. As a general rule, loans were to be for specific projects, and these projects were to be carefully studied. Arrangements were made to ensure that the proceeds of the loan were used only for those purposes for which the loan was granted. Interest and other charges on the loan were to be reasonable, and the schedule for repayment of principal was to be appropriate to the project.

In other words, the Bank would lend carefully. No loans were to go for military expenditures or for uneconomic show projects. Disbursements would be monitored to prevent graft. Ideally, the Bank would lend for projects that would increase the borrower's productive capacity. This, in turn, would provide the means for repaying the borrowed funds and interest on them.

The Bank has operated in this manner for many years. In the 1950s and most of the 1960s, the Bank was concerned with "hard" projects such as roads, hydroelectric dams, power stations, and irrigation works. With the arrival at the Bank of Robert McNamara in 1968, the Bank got increasingly involved in "soft" projects: education, rural development, poverty alleviation, public health, and family planning.

In the late 1970s, however, the Bank encountered criticism that a project could not be divorced from its economic context. If the country's macroeconomic conditions were unstable, a new road system might not be used, and insufficient government revenue would preclude proper maintenance. Thus, a road loan would burden the borrower with debt without providing an appropriate rate of return on the money borrowed. The Bank's answer to this issue was to promote macroeconomic stability through quick-disbursing balance of payment support to countries willing to agree with the Bank on a program of structural adjustment. Thus began the structural adjustment lending, with the first of these loans being made in 1980.

The content of a structural adjustment program depends on the economic situation of the adjusting country. Such a program often includes (1) adjustments of the exchange rate to make exports competitive and imports fairly priced, (2) changes in trade policies to remove quantitative restrictions on imports, (3) changes in fiscal policies (particularly tax reform) and in the public sector (including restructuring and possible privatization), (4) financial sector reform (including adjusting interest rates), and (5) price reform, particularly in agriculture and energy.

More interesting are the changes made by countries moving from a command economy to a market-oriented one. These countries must build whole new legal systems, beginning with legislation to define property rights (including who will own and control corporations). Then the countries must pass a panoply of laws to create a market economy: a commercial code, antitrust laws, securities regulations, a bankruptcy code, bank regulation, and so on. It is also necessary to develop an accounting profession and a legal profession. For example, the Bank is active in Poland, where it is negotiating a structural adjustment loan directed at industrial restructuring, development of a social safety net, and reform of the banking system.

Before making a structural adjustment loan, the Bank must receive from the borrowing government a letter setting out the borrower's plan for its economic adjustment, usually referred to as the letter of development policy. Its terms are referred to in the loan agreement, which differs from the usual Bank loan agreement in having no covenants relating to performance. Of course, there are still covenants relating to the payment of interest and principal.

The Bank ensures that the economic program will be carried out by dividing the loan into two or more tranches. Each tranche has specific conditions attached to it, and the tranche amount is not disbursed until the conditions are satisfied. For example, suppose country *X* has many state-owned enterprises that run at a loss and thus substantially increase the government's fiscal deficit. The Bank makes a loan for $200 million in two tranches of $100 million. The first tranche condition might be that the government agree with the Bank on a plan for dealing with a certain number of these enterprises—either through reorganizing them, privatizing them, or closing them down. When the plan is agreed, the first tranche ($100 million) is disbursed. The second-tranche conditions are normally designed so that they can be completed within six months to a year. In hypothetical country *X*, the second-tranche conditions might require that the plan for dealing with the public sector be carried out to the Bank's satisfaction. When this is done, the second tranche is disbursed.

A normal Bank loan is disbursed against expenditures on the financed project and takes, on average, five to six years to be disbursed. A structural adjustment loan, because it is balance of payments support, is disbursed against general imports and can, therefore, be drawn down rapidly.

The legal justification for structural adjustment loans has been much discussed within the Bank. Attention has been focused on whether financing general imports satisfies the "productive purposes" requirement in the Bank's Articles of Agreement. It should be noted that the Articles provide for their interpretation by the Bank's Executive Directors, with the possibility of appeal to the Board of Governors. Such an interpretation is final and binding. This does not mean that the Executive Directors have license to amend the Articles under the guise of interpretation. The Bank is engaged in commercial operations, borrowing about $10 billion a year on private capital markets. The Articles' requirements, particularly those ensuring prudent operations, cannot be interpreted out of existence.

To date, the Executive Directors have given 13 formal interpretations of the Articles. No interpretation has been appealed to the Board of Governors. The third interpretation made by the Executive Directors confirmed the power of the Bank to make stabilization loans. It is on the basis of this interpretation that structural adjustment loans to cover balance of payments deficits are legally justified. The economic program agreed with the

Bank is not to be seen as a project financed by the Bank. The Bank does not, so to speak, bribe the borrower to reform its economy. A structural adjustment loan is to cover a balance of payments shortfall, and the Bank is willing to make such a loan only if the borrower reforms its economic structure.

It has been the Bank's experience that structural reforms in an economy will not be effective or lasting if the country's macroeconomic situation is unbalanced. Therefore, macroeconomic reforms are a prerequisite for any adjustment lending by the Bank. The Bank coordinates such work closely with the International Monetary Fund. In almost all countries where the Bank is making adjustment loans, the Fund will have a stand-by arrangement.

Not all of the Bank's structural adjustment loans in the past decade have met success. In most economies, private investment is the real engine of growth. The main purpose of adjustment is to provide the preconditions that encourage a high level of productive investment by the private sector. Long-run growth can only be achieved when individuals prefer to invest domestically instead of abroad or when foreign investment is attracted to a country. This only happens when the productivity of that investment is high and is expected to remain so in the future. Investment is a function of confidence, which can take time to rebuild in a country that has had economic difficulties. The supply response resulting from a country's structural adjustment may be considerably delayed. The Bank and the Fund now have a large amount of experience implementing adjustment programs and understand better the phasing and complexities of these programs. One can, therefore, expect adjustment programs to succeed more fully than in the past.

Sectoral adjustment lending was started in 1983 and should absorb an increasing share of adjustment programs over time. This form of adjustment is limited to basic changes at the sectoral level, as opposed to adjustment that is concerned with the economy as the whole.

The Bank is also making so-called hybrid loans, which combine sectoral adjustment loans with investment loans in that sector. The combination produces mutually re-enforcing benefits: the sectoral adjustment loan encourages reform in the way the government regulates the sector, and the country benefits from the supply response of the investment project to the reforms made in the sector.

Debt Reduction

As mentioned above, the confidence of private investors is crucial in ensuring the supply response to adjustment policies. In highly indebted countries, the external debt often creates uncertainties about the sus-

tainability of the balance of payments situation and about macroeconomic stability generally. These uncertainties may also thwart the recovery of private investment. Debt reduction in the context of adjustment programs can help reduce these uncertainties.

The debt problem arrived with the Mexican crisis in September 1982. In the summer of 1982, the various ratios that indicate the burden of indebtedness, such as the ratio of debt service to export earnings, were not considered out of line with historical experience. Nonetheless, a sharp recession in the world economy owing to declining commodity prices—for oil, metals, coffee, and cocoa—caused a serious situation to develop. Interest rates rose rapidly in developed countries, and these increases immediately affected developing countries through interest adjustments on variable-rate commercial bank loans. In addition, voluntary lending by commercial banks ceased for many developing countries.

At first, it was hoped that the debt problems were temporary and would pass, given appropriate adjustment in the debtor countries, a revival of commodity prices, and a return of interest rates to more normal levels. The International Monetary Fund was particularly active in this initial period in arranging stand-by credit for the heavily indebted countries.

Although by 1985 the crisis atmosphere had lifted, the situation had not improved substantially. At the Bank and Fund Annual Meetings in Korea that year, the U.S. Secretary of the Treasury, James Baker, announced an initiative. The heavily indebted countries (15 on a list provided by Secretary Baker) were to grow out of their debt. The approach to the debt overhang shifted from short-term balance of payments stabilization to longer-term development objectives.

The plan called for structural reform by the heavily indebted countries in three major areas: trade liberalization, liberalization of direct foreign investment, and reform of the state enterprise sector, including possible privatization. Under the plan, commercial banks were to extend new lending of $7 billion annually over three years to the 15 Baker countries. The Bank, the Fund, and other multinational financial institutions were to increase net disbursements to these countries by $3 billion annually during the three-year period, for a total of $9 billion.

The results of the Baker Plan were mixed. The plan prevented the debt problem from again becoming a crisis but did not do much to solve the problem. The multinational development banks increased lending substantially to the Baker countries, but private lending fell badly short of plan targets. The share of the official sector in the total outstanding debts of heavily indebted middle-income countries increased from 14 percent in 1982 to 30 percent in 1988.

Many of the heavily indebted countries made serious efforts at adjustment but several were unable to attempt it. As the decade closed, the

accumulated debt became a serious problem. For the past several years, academics and politicians have advocated a series of initiatives that would involve a more aggressive approach to the debt problem.

A private secondary market had developed in commercial bank debt of the heavily indebted countries, in which relatively small amounts of this debt were traded at very substantial discounts—typically 50 percent to 60 percent, but going as high as 90 percent. Several of the new debt initiatives involve the country itself taking advantage of these discounts. Under the usual syndication agreements governing commercial bank loans, a country is not permitted to buy its debt directly. In any case, trading in the secondary market had been in small amounts, and any major buy-back would have greatly increased the cost of trades.

In March 1989, Treasury Secretary Nicholas Brady spoke to the Bretton Woods Committee, and named debt and debt-service reduction as possible options for commercial bank debt, proposing that the Bank and Fund provide funds to support this goal. Both institutions responded rapidly and positively. The Bank's Executive Directors approved guidelines for the debt and debt-service reduction in May 1989.

To undertake debt reduction, however, the Bank had to overcome a major problem—arranging the necessary financing. Although it was not clear that the Articles of Agreement authorized lending for this purpose, the Bank's General Counsel had often invoked the doctrine of implied powers in deciding whether certain activities could be done. This doctrine holds that the Bank can do anything consistent with its purposes as long as it was not specifically prohibited in the Articles. Article I, entitled "Purposes," states:

> The purposes of the Bank are:
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> (i) To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes . . .
>
> (ii) To promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, 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 . . .
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> The Bank shall be guided in all its decisions by the purposes set forth above.

These purposes clearly supported the Bank's power to lend for new investment. The Bank's power to lend for debt reduction, however, was not as clear. The drafting history of the Articles is, on the whole, negative with regard to the power to lend for debt reduction. Early drafts of the Articles contained provisions authorizing the refinancing of debt, but such refinancing was either limited to a specific percentage of the portfolio (10 percent) or required a special majority for approval (80 percent).

These provisions were dropped in later drafts and never reappeared. In the 1970s, when the Bank was expanding the types of activities for which it would lend (for example, health care and family planning), it was thought that the Bank would have great difficulty in justifying loans for the refinancing of existing debt, although no definitive position was taken on this question. It took until the 1980s, and the crippling debt crisis, for the Bank to rethink this. In April 1988, the Bank's General Counsel decided that the Articles would permit the Bank, in certain circumstances, to finance debt or debt-service reduction.

It was not enough for the borrower simply to benefit from the transaction or for the transaction to earn a high rate of return, however. Debt reduction could be financed only if it materially increased investment in the borrowing country. In other words, the borrower would have to gain material benefits that went beyond a reduction of its debt-service obligation. In particular, the Bank's intervention should demonstrably assist the country in receiving or making investments for productive purposes that would otherwise not take place. All operations with regard to debt must meet this materiality test. Materiality criteria were further spelled out in a paper approved by the Executive Directors. It provided that the Bank may be involved in funding debt and debt-service reduction operations only when (1) the intervention is critical to the success of the adjustment program or policy framework; (2) the resulting reduction in debt-service obligations enables the borrower to have a financing plan that effectively supports the country's strategy for adjustment and growth; and (3) the Bank is satisfied that the resulting savings will not be used to finance unproductive purposes. It further provided that, in evaluating items (1) and (2), the Bank shall pay attention to the magnitude of the discount being achieved and the overall size and significance of the transaction being assisted, together with the likely impact of the transaction in establishing a basis for further debt-reduction activities, as part of an agreed strategy to strengthen the country's creditworthiness, promote the repatriation of flight capital, and engender higher domestic savings. The overall size and significance of the transaction being assisted is to be judged not in absolute terms but relative to a country's debt burden and the size of its economy.

The Bank works very closely with the International Monetary Fund on debt operations, but the Fund has broader powers under its Articles of Agreement to support these operations and is not limited by a materiality test.

Before discussing the Bank's guidelines on debt operations more specifically, it is important to discuss the distinction between debt reduction and debt-service reduction.

Debt reduction involves reducing the principal (as opposed to the interest), either by buying back the debt at a discount for cash or by exchanging a smaller principal amount in the form of new securities for the original debt. These two approaches would extinguish the interest obligation on the principal amount redeemed or reduced. Debt-service reduction, on the other hand, only lowers the amount of interest payable on the debt, either for the life of the debt or for a shorter period, after which interest payments would revert to their original amounts. The principal is not affected. For a given amount of money, debt-service reduction provides greater immediate relief and is an effective approach when the country's problems result from a temporary lack of liquidity. In addition, if the whole principal is to be paid, interest payments can be sharply reduced without the debt having to be written down on the creditors' books.

At the time that Secretary Brady made his speech in 1989, debt-service reduction had been the preferred approach in negotiated settlements. Yet, some member governments thought that too heavy a reliance on debt-service reduction might raise political difficulties. They feared that after several years of financing debt-service reduction, with no real reduction in the principal, efforts to continue difficult economic programs would be questioned. For this reason the Bank was forced to maintain two pockets for debt operations. Eligible countries could receive "set-aside" funds equal to 25 percent of the planned adjustment lending for the next three years for operations involving principal reduction, either through cash buy-backs or debt exchanges that led to principal reduction. That was one of the pockets. In the other pocket were "additional resources" of up to 15 percent of the Bank's overall three-year lending program for a country, which could also be made available. Such funds were to be used only to provide interest support. Thus, principal reduction came out of set-aside funds and interest reduction came out of additional resources. Each pocket had about $6 billion, for a total of $12 billion over the three years starting in July 1989.

These are total amounts that could be made available. The amounts that each country would actually receive would depend on its lending program. The funds in each pocket are not fungible: additional resources cannot be used for principal reduction and set-aside funds cannot be used for interest support. This has created an awkward problem for the Bank. For political reasons, the demand for principal reduction has been greater than that for debt-service reduction. Nonetheless, governments still argue that separate pockets should be maintained.

The Bank's operational guidelines require that a country meet the following criteria in order to be eligible for support for debt reduction. First, the country needs to have a medium-term structural adjustment program acceptable to the Bank. Second, the country needs to show that the debt

and debt-service reduction is essential for achieving its medium-term adjustment targets. Third, the country needs to provide a sound financing plan that promises substantial benefits and represents an efficient use of the Bank resources. Finally, the resources used for debt and debt-service reduction need to make a material contribution to the country's growth and development (the materiality test mentioned above). In all cases, transactions supported by the Bank should result in substantial reduction in the present value of future debt-service obligations.

Support for debt and debt-service reduction is usually provided through direct lending arrangements on normal Bank terms. As noted earlier, the borrowing country can use ***set-aside resources*** for reducing its stock of outstanding debt through buy-backs or debt exchanges. It can use ***additional resources*** for interest payment and credit enhancement programs in connection with debt and debt-service reduction. In exceptional circumstances, the Bank may also consider providing interest support through a guarantee of a fixed number of interest payments, although this type of financing is not popular with the Bank's Executive Directors.

The Bank does not become involved in the negotiations between the member country and its commercial creditors and insists that a market-based deal be struck. The Bank actively monitors the progress of such negotiations and must be satisfied with the overall outcome. As a result, the Bank's procedure for approving funding for debt reduction is a two-step process. First, a decision is made on the maximum amount of funding to be made available, which may happen before the financing package has been agreed between the country and its commercial bank advisory committee. Second, the funds are released only after the details of the financing package have become known.

I would like to mention two examples of the Bank's debt operations. The first and largest was in Mexico, where commercial bank creditors were given three options. First, they could exchange their debt at a discount for collateralized floating-rate 20-year bonds. One hundred dollars of debt could be exchanged for $65 of these bonds. Payment of the full principal of the bonds would be secured by a deposit of zero-coupon U.S. Treasury securities. Up to 18 months' of interest would also be collateralized. Second, creditors could exchange debt at par—at 100 cents on the dollar—for 20-year collateralized fixed-rate bonds. The interest rate on these bonds would be 6.25 percent per annum, a rate substantially below the market rate. The principal and interest would be secured in the same way as the discount bond. The third option allowed creditors to supply new loans to Mexico.

It is interesting to see how the commercial banks actually exercised their options in Mexico. Banks representing 46 percent of the principal chose the par bonds (the second option), 38 percent chose discount bonds, and

only 15 percent lent new money. Creditors who chose par or discount bonds could, in the future, recapture a part of their losses if the price of oil rose above a certain level.

The Bank loaned $750 million in set-aside funds for collateralizing the discount bonds and $1.26 billion in a single interest-support loan to collateralize interest payments. The interest-support loan was the largest loan the Bank had ever made to that point. The Fund was to make $1.7 billion available for the Mexican operation.

The second debt operation was in the Philippines. Although negotiations started later, this transaction was completed before the Mexican refinancing. In the Philippines, the Bank made a loan of $200 million for a buy-back of commercial bank debt at a 50 percent discount. The Bank has also worked on debt operations in a number of other countries. In a review of such operations, the Bank's Executive Directors had generally positive remarks about the results. The Bank, however, must continue to ensure that the underlying adjustment programs and financing plans are sufficiently robust and durable to provide against undesirable outcomes in borrowing countries.

It is a natural result of the dynamics of the negotiations between the commercial banks and the debtor country that a refinancing deal will be based on optimistic assumptions about the future of the debtor's economy. These negotiations are difficult and the debtor country is not able to obtain concessions unless they are clearly necessary. To the extent that one concession is granted, others must be surrendered, or the total cost of the deal rises. The Bank and the Fund usually supply negotiating parties with figures on the estimated financing gap for the medium term. This financing gap must be filled, either with new money or with a reduction in debt payments. These estimates have, on occasion, been regarded as too pessimistic, therefore necessitating more resources. In many of these cases, the negotiators have arranged the refinancing on more optimistic assumptions, which can be dangerous if the agreed gap of X million dollars turns out to be $X + Y$ million dollars. The country, then, must find additional funds or face further debt defaults.

In a pre-Brady situation, the country would have been able to go to a commercial bank advisory committee and work out new arrangements. Under some of the completed or contemplated debt settlements, much of this new money base has disappeared, and many commercial banks have exited with bonds, sometimes in bearer form. In such a situation, the country might not know the identity of the holders of its bonds until it defaulted on its payments. Bonded debt does not have the flexibility that bank loans do. A country with a large bonded debt is less able to respond to unforeseen circumstances. One of the problems with current debt reduction structures is that relatively flexible commercial bank loans have

been replaced with relatively inflexible bonds. At the same time, commercial banks in debtor countries have not been enthusiastic about negotiating contingency lines of credit that could be drawn on in emergencies. Deals often provide for commercial banks to recoup some of their losses if events in the medium term turn out better than expected. It would seem only fair that banks provide additional financing if the future is less rosy than anticipated.

Not only the middle-income countries are heavily indebted. Many of the low-income countries (sometimes referred to as "IDA only" countries) have very heavy debt burdens. Most of the debt of these countries is official debt, though there is some commercial bank debt.

A great frustration in Bank lending is seeing scarce concessional funds from the International Development Association going to countries that use the breathing space such finance provides to pay commercial creditors instead of making more fundamental economic reform. The Bank has taken action to assist low-income countries with their commercial debt problem. At the 1990 Annual Meetings in Washington, the Board of Governors of the World Bank approved a $100 million transfer from the Bank's net income to a special three-year debt reduction facility for low-income countries that have access to Bank resources only through the International Development Association (hence, "IDA only"). Other donors may provide resources to supplement those made available by the Bank. The special funds are made available to eligible countries as grants to finance commercial debt reduction mainly through cash buy-backs.

Commercial debt reduction in such countries has not received as much attention as reduction of official debts, which is understandable given that commercial debt accounted for only a small part of their total external debt. However, commercial debt often carries higher interest rates, and in some cases the servicing of commercial debt must be continued while official debt can be rescheduled or in arrears. Although the immediate cash savings from commercial debt reduction in low-income countries is likely to be modest, commercial debt reduction may be expected to produce other benefits. In the short term, prospects for further overall debt reduction can be improved because official lenders' concerns over equitable burden sharing with private creditors are reduced. Large expected discounts (in many cases up to 90 percent) mean that even relatively small buy-backs can have a substantial effect on debt stocks. At the same time, debt reduction may increase access to short-term trade credit at reasonable rates. In the long term, commercial debt reduction is probably a necessary, although not a sufficient, condition for an eventual rise in creditworthiness, given a credible overall debt management strategy. Since financing is limited, individual countries may not receive more than $10 million from this new facility, although these funds can be supplemented by resources

made available to the country by other donors. In order to achieve the purpose of the facility, only countries with an ongoing adjustment program, and a credible debt management program, for both commercial and official debt, are eligible to use the facility.

The debt management program must materially enhance the country's growth and development prospects. Because management capabilities are limited in many low-income countries, technical assistance is available. Facility resources take the form of grants in order to have maximum impact and achieve as much debt reduction as possible. It is expected that most operations will be cash buy-backs at substantial discounts. However, debt exchanges may be supported if they constitute a more efficient use of resources. Buy-backs at a deep discount are difficult to negotiate. One reason for this difficulty is that when a creditor perceives that money is available to enable the debtor to repurchase the debt, the price of the debt is likely to rise in response.

COMMENT

T.M.C. ASSER

A question that is often asked about the International Monetary Fund and the World Bank concerns the differences in the policies and practices that the institutions pursue in providing financial assistance to their member countries, especially for the purpose of supporting programs designed to improve a nation's economy. Although both institutions provide such assistance, there are significant differences between them, both as to the focus of the assistance that they provide and as to the delivery of that assistance.

As Mr. Scott explained, the World Bank was established as a project finance institution. Indeed, the Bank's Articles of Agreement provide: "Loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction or development." Structural adjustment loans are not loans made by the Bank for the purpose of a specific project. Consequently, for the World Bank, structural adjustment loans must be the exception rather than the rule.

For the Fund this is different. The Fund does not provide financing for the purposes of specific projects but for purposes related to the balance of payments position of the recipient member country. According to the Articles of Agreement of the Fund, a Fund member shall be entitled to receive financial assistance from the Fund's general resources on condition that the member represents that it has a need for such assistance "because of its balance of payments or its reserve position or developments in its reserves." As a rule, Fund financing is balance of payments financing.

These differences in operational focus between the two institutions—for the Fund a balance of payments focus, and for the World Bank a project focus—reflect the different statutory goals of the two institutions.

The Fund was established, among other things, to provide the machinery for cooperation and consultation on international monetary problems. For instance, the Fund has exclusive jurisdiction over exchange rate matters; as such, the Fund must oversee the international monetary system and the compliance of members with their obligations under the Fund's Articles in this area. In the area of financial assistance, where the Fund and

the World Bank complement each other, the Fund is primarily concerned with balance of payments, growth-oriented stabilization policies and their related instruments.

The World Bank has no mandate with respect to exchange rates. The World Bank is charged with promoting economic growth and conditions conducive to efficient resource allocation. Thus, the Bank focuses on development strategies, sector and project investments, structural adjustment programs, and related areas.

In practice, however, these differences in economic focus between the two institutions are somewhat artificial. For instance, the success of microeconomic policies pursued by the World Bank will in part depend on the success of macroeconomic policies pursued by the Fund. Even at the macroeconomic level, the distinction between growth-oriented stabilization programs and development-oriented structural adjustment programs is not always easy to understand, at least not for us lawyers.

Generally speaking, the Fund may be said to approach a country's economy from the top down whereas the World Bank does this from the bottom up. Although it is not difficult to see why the Fund can restrict the scope of its involvement to macroeconomic issues, it is far less clear how the Bank can restrict its interests to microeconomic issues. Even if the Bank restricted its financial assistance to project aid—which it does not—the Bank must be concerned with the macroeconomic policy framework of the country, because that framework affects the success of the projects that it helps finance, including the country's ability to service its World Bank loans.

A project example may serve to illustrate. Assume that the World Bank receives a request from one of its member countries to help finance an electric power generation project. Before the Bank can agree to the request, it has to determine, in accordance with its lending policies, whether the project's economic rate of return is acceptable. The rate of return depends on a number of conditions. These include the necessary physical infrastructure, such as a power distribution network to transport the power to the consumers, and economic conditions, such as a sufficient demand for power at adequate power rate levels. The demand for power, in turn, depends on the macroeconomic conditions prevailing in the country: if these are unfavorable, the demand for electric power will be less than that required to generate a healthy rate of return. Therefore, the World Bank will have a keen interest in the macroeconomic policy framework of the country.

This brings me to what may be the most compelling reason why both institutions have a strong interest in the financial well-being of the countries to which they provide financial assistance. It is the ability of the

country to meet its external debt obligations, including in particular the country's financial obligations toward the Bank and the Fund.

Economic stabilization programs that are supported by financial assistance from the Fund are specifically designed to meet that goal. Although, for the World Bank, this is generally true for programs of structural adjustment that are supported by program loans, it applies only rarely with respect to World Bank projects. True, there are some projects that are designed to earn foreign exchange through exports or to save foreign exchange through import substitution, and thus to help countries meet their external debt obligations—petroleum, natural gas, and mining projects come to mind. For most of its project financing, however, the World Bank relies on macroeconomic developments to assure timely debt service.

It can be seen from the foregoing that there is a shared concern between the Fund and the Bank that the countries to which they provide financial assistance maintain appropriate macroeconomic policies. This shared concern has produced close cooperation between the institutions, especially in the design of economic programs. Despite occasional speculation in the press to the contrary, cooperation between the Fund and the World Bank has always been excellent.

Another topic discussed by Mr. Scott that concerns both the Fund and the World Bank is the preferred creditor status of the institutions. During the last decade or so, this status has repeatedly been recognized by official and commercial creditors alike in connection with debt-rescheduling operations. In practice, the preferred creditor status of the institutions consists of two elements, namely: (i) the permission granted to the debtor country by its official creditors (Paris Club) and its commercial creditors to continue debt-service payments to the Fund and the World Bank during rescheduling negotiations, even while debt-service payments to those creditors are suspended; and (ii) the agreement of those creditors that, unlike other creditors, the Fund and the World Bank need not participate in debt-rescheduling arrangements or debt-reduction operations.

One of the arguments supporting such a preferred creditor status is that during debt-rescheduling negotiations, when other creditors no longer make funds available to a debtor country, the Bank and Fund continue to provide financial assistance, as long as the country continues to meet its debt-service obligations to the two institutions. This preferred creditor status of the Fund and the Bank is not based on any legal requirement; no treaty provision forces commercial or even official creditors to accord preference to the financial claims of the Bank and the Fund. The practice has simply evolved and is now an accepted part of debt-rescheduling and debt-reduction operations.

The international debt crisis during the 1980s, and in particular the attempts to resolve that crisis, have raised several interesting legal questions. One of these concerns the proposal included in the so-called Brady Plan, which was launched in March 1989, to extend in advance of any rescheduling negotiations a blanket waiver of the negative pledge covenants in international loan agreements.

It is unclear why such waivers given in advance would be necessary or even appropriate. Such blanket waivers would deprive the banks of an important negotiating chip. Moreover, in the past, it has not been exceptionally difficult to obtain from commercial lenders waivers of loan covenants when these were required to support a particular debt-reduction or debt-rescheduling operation.

One reason for this proposal of Secretary Brady is that it would facilitate the collateralization of debt-rescheduling operations or new financing extended in connection with such operations. The Mexican-debt rescheduling that was described by Mr. Scott, where United States Treasury bonds are used to collateralize Mexican debt-service obligations, is an example of such a transaction.

Although the Fund does not use negative pledge covenants in its operations, the World Bank does. One of the questions raised by the Brady proposal is whether a blanket negative pledge waiver, as suggested by Secretary Brady, when granted by the World Bank would affect its preferred creditor status, and, if so, whether this would affect the Fund's preferred creditor status as well. After all, creditors whose claims were secured by the collateral in which the Bank and the Fund did not share would by definition have a creditor position senior to that of the Fund and the Bank.

This question is all the more serious because it must be feared that the issuing of international loan collateral by a country will adversely affect its ability to obtain unsecured international loans thereafter. Once a country gives collateral to secure some of its external debt, no creditor will wish to lend thereafter to that country without similar collateral, unless the country's creditworthiness improves dramatically. This snowball effect would further undermine the preferred creditor status of the World Bank and the Fund.

It should be noted that the so-called preferred creditor status of the two institutions can be maintained only as long as the balance of payments situation of the country concerned permits the rescheduling of its bilateral and commercial external debt without the rescheduling of Fund or World Bank financing. The possibility of a country's rescheduling without Fund and Bank participation depends largely on the amount of foreign exchange reserves available to service the unsecured external debt. If some portion of

the debt is collateralized, then the share of the Fund and the World Bank in the remaining unsecured external debt increases, exposing them to an increased risk that without their participation the country's unsecured external debt cannot be rescheduled. Thus, they may be forced to participate in the debt-rescheduling operation.