**THE FUTURE OF THE WORLD BANK[[1]](#footnote-1)**

words

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World economy has attained unprecedented level of growth since World War II. Growth rates attained in last quarter century have lifted hundreds of millions of people out of poverty. Unleashing and energizing private enterprise under an open trading system and an enabling market friendly economic environment has made a difference. We also know by now what stifles growth – excessive taxation, red tape and bureaucratic corruption, inadequate infrastructure, high inflation and poorly educated labour force.

The World Bank kept adapting its role during the last five decades in response to the changing challenges. From a reconstruction agency responding to the needs of Europe it began to help the infrastructure needs of the newly independent developing countries through its project lending. Under President McNamara it turned its attention towards poverty reduction which continues to be its mission till today. The Bank along with the Fund played an important role in moving towards Structural Reforms in the 1980s and reshaped the policy advice embracing many of the elements of the so called Washington Consensus – openness to trade, Macroeconomic Stability, Fiscal discipline, Central bank independence. China and East Asian experience made some shift in the emphasis towards Mixed, pragmatic strategies particularly extensive reforms of governance and attention to human development. In more recent period the World Bank was making a conscious attempt to move in the direction of becoming a Knowledge Bank.

The dynamics of the world economy has changed. Since 1990s, the growth in the Emerging and Developing Economies (EDEs) has been substantially above that in Advanced Countries (ACs). By 2025-30 per capita incomes of EDEs will also become much closer to those of the ACs. Under this dynamic scenario and taking account of the biggest unanticipated shock to the World economy since the Great Depression of the 1930s that has caused major disruption in the global economic trajectory it is relevant to examine the future role of the multilateral institutions such as the World Bank and the International Monetary Fund (IMF). The recent change in the top leadership of the World Bank also provides an excellent opportunity for rethinking the mission of the Bank for the next few 15-20 years. In the past the changes in the stewardship at the Bank primarily focused on the internal organization and processes rather than initiated a systematic look at the substantive agenda. It is time to look at the Bank’s strategic agenda for the future. The two main planks of the current World Bank strategy of poverty reduction are:

1. Lending to low income countries on concessional terms and
2. Policy advice from the Knowledge Bank – a reservoir of data and analysis.

Both these planks, in my view, are under threat for the future positioning of the Bank for the reasons that I would like to elaborate.

**Poverty Reduction**

World Bank has been lending to low income countries by mobilizing concessional resources from the donor countries. The distinction between the rich countries as donors and poor countries as recipients is breaking down as other binary classification such as Developing and Developed Countries, First world and Third world. North and South. China, although a country with per capita income of US$4,000/- is contributing to the rescue funds for the peripheral countries in Eurozone with per capita incomes several times higher than that of China.

Countries where most of the world’s poor live are no longer low income but belong to middle income category. 400 million poor live in India and Pakistan, both of whom are no longer low income countries. So far, they have been blend countries drawing a mix of concessional and non-concessional resource. Going ahead, should the tax payers in UK, for example, be asked to contribute to IDA to assist India which is buying assets in the UK and is perceived to be displacing domestic jobs through outsourcing? Will Sub-Saharan African countries approach the World Bank for infrastructure projects with all its conditionalities, procedures and supervision when China is pouring in unconditional resources in volumes much higher than the Bank? Whether countries such as Bangladesh receiving workers’ remittances four times the level of official aid and with their foreign exchange constraint having been relaxed, be persuaded to take loans from IDA– even concessional?

In the competing space of residual demand for multilateral concessional assistance, would the low income countries feel more comfortable in accessing the Regional Development Banks (RDBs) with whom they have a sense of ownership rather than the far distant Western dominated World Bank and the IMF. The RDBs have proved to be more responsive in times of distress and difficulties for these countries compared to the World Bank.

The success in combating poverty during the last three decades has resulted in the achievement of the MDG goal of halving the rate of poverty incidence five years ahead of 2015 – the target year. Accelerated and broadly spread growth rates in all the six continents have made this possible. The trend for the future points to a continued domestic effort in pursuing sound macroeconomic policies and building strong institutional framework by a majority of the countries. As many as 80 countries have recorded 4 percent growth per annum in this decade. The substitution of good policies and sound institutions has improved the efficiency of capital utilized and increased domestic resource mobilization. In that event, reliance upon external financing is no longer that compelling as it was in the past five decades.

Assuming that there would be some countries where the gap between domestic savings and investments would require them to tap foreign savings. The choices available to these countries today and in future are manifold. Unconditional and large flows from China to Sub-Saharan Africa for long gestation infrastructure projects, rising workers’ remittances to South Asian countries and the increased flows from Regional Development Banks (RDBs) will continue to be major sources of external financing. But as countries improve their macroeconomic and business environment and pursue sensible economic policies they would attract private capital flows in form of Foreign Direct Investment, Portfolio Investment, Private Equity, Private-Public Partnerships, for financing the same kind of projects which had been traditionally the forte’ of the World Bank. To what extent would the Bank’s lending for poverty reduction remain its main plank in the future?

**Policy Advice**

The Banks policy advice to member countries has always been influenced by the cutting edge frontiers of Development Economics. In the early stages of its formation the Bank followed the Big Push theory through its project lending to build physical infrastructure. Economists at that time believed that lack of physical Capital was the binding constraint on growth of newly independent developing countries and the Bank should help building this Capital. When industrialization emerged as the principal harbinger of economic transformation the Bank financed industrial projects. Two gap model then shifted the direction towards filling in the foreign exchange gap through program lending. As several empirical studies established showing the flaws of import substitution, financial repression, inward looking strategies the Bank moved its direction towards Liberalization, Privatization and Deregulation – the so called Structural Adjustment Programs (SAPs). Although many academics and civil society organizations took serious issues with the Washington consensus that provided underpinning to SAPs but the components of that agenda were based on solid empirical research and analytical studies carried out within and outside the Bank. But today the consensus on the alternative paradigm that guides and shapes the policy advice of the World Bank has eroded. Following the Global financial crisis of 2008-09 the intellectual underpinning of economic policy management and reforms is being seriously questioned.

It is argued that Markets economies are not automatic self-stabilizing and are not self-correcting and self-regulation as we popularly believed. Minimal government interference or deregulation does not always work especially when there is a crisis, panic or contagion. Efficient market hypothesis and its associated offshoots have brought more harm to the society than benefits. The myth that financial innovation transfers risks to those best able to bear has exploded. Rationality of economic actor and the maximization of expected utility are being challenged by behavioral economist. They believe that ‘reference points’, ‘loss aversion’ and ‘Endowment effect’ will make the utility theory forward looking.

Under the above conditions where the analytical and empirical foundations of the Bank advice about policies and institutional framework have become shaky what would be in the tool kit of the Bank to advise the member countries when they seek it out.

On the broader horizon, I hardly see any Keynes, Friedman or Hayek challenging the conventional wisdom and coming up with alternative paradigms that adequately explain the weakness and failures of the recent past and guide the future policy advice.

I now turn towards the emerging issues that we are likely to face in the coming decades. The three main emerging issues on the horizon on the basis of our current reading of evidence that will face the member countries of the Bank are:

1. Rising inequality
2. Climate change
3. Financial System Stability

My question is: whether the Bank is prepared and equipped to respond to these challenges?

**Inequality**

Inequality – Income, Regional, Gender Rural/ Urban – has increased in almost all countries with a few exceptions such as Brazil. How much it is attributable to global competition, addition to global work force or technological innovation is an ongoing unsettled debate. There are popular perceptions in the western countries that International trade and outsourcing have exacerbated inequality, accentuated labour market risks and eroded the social compact within nations. Liberalization of trade and removal of barriers – tariffs and non-tariffs – have made a significant difference in the wellbeing and welfare of most trading countries. But it is puzzling that those who were preaching trade liberalization to developing countries till yesterday are now finding all sorts of arguments to justify protectionism. Doha Round has been a disappointment but bilateral and regional free trade arrangements have multiplied. The potential gains from trade can be dissipated if the popular view that international trade leads to inequality becomes widely accepted. Here the Bank can engage in the battle as its intellectual armoury in this field has remained unscathed.

The nature of technological change, increased skill premium, huge expansion of global market, winner-take-all characteristics of many markets, mobility of capital rather than labour have all influence on the outcome of income distribution. But domestic economic policies and institutional restructuring have also failed to take corrective actions. Both in democratic India and non-democratic China growth has accelerated, poverty has been reduced but Gini coefficients have gone up. The difference in per capita income in Bihar and Maharashtra has risen fourfold. China’s Coastal provinces enjoy incomes several times higher income levels than the Western provinces. Social safety nets do not exist anymore while the number of billionaires is rising every year. The problem of inequality is quite widespread both in the Advanced and Emerging countries. The current average income of the richest 10 percent of the population of 34 OECD countries is nine times that of the poorest 10 percent. This trend of rising inequality and higher expectations is an explosive mix for social upheaval and divisiveness in many countries as empirical evidence shows that high levels of income inequality are associated with increased social instability. What kind of policies and institutional reforms can be put in place to address this challenge? What can the World Bank to help these countries to reverse this trend?

**Climate Change**

The scientific evidence on the impact of carbon emissions and consequential climate change is becoming stronger with the passage of time. Skillful management of this global public good is going to be one of the toughest challenge the nations of the world are likely to face. The World Bank being a cooperative body owned by more than 180 counties can play a critical role in the climate change agenda which otherwise will put health, water resources, energy, food security, poverty, forestry, bio-diversity, fisheries and environment in developing counties to catastrophic risks. But the Bank doesn’t have a clear mandate so far. As it doesn’t have the mandate it is short of resources and multidisciplinary expertise. Will the international community feel comfortable in entrusting the leadership role to the Bank for this agenda? There are many players involved for a long time in this area each one competing for a slice of the cake. Will they concede the leadership role to the World Bank?

The Clean Energy Investment Framework in which the Bank is playing a lead role in mobilizing resources for investment in lower carbon energy can be taken as a practical manifestation of this confidence. But this is only one of many components of the agenda that need to be addressed.

As the climate change would create disruptive and differentiated impact on many countries and the solutions for mitigation and adaption would be regional, will the Bank be able to act as a neutral umpire, financier and facilitator? In the 1960s it performed this role well in bringing India and Pakistan to agree to the Indus water Treaty which is still effective after fifty years. It is difficult to envisage an international body other than the World Bank capable of carrying out this responsibility. Scarcity, depletion and competing demands on the shared natural resources are likely to give rise to disputes. Can the World Bank become an arbiter in resolution of these disputes?

**Financial System Stability**

Financial markets have become interconnected and global with strong spillover effects and contagion affecting other countries but there is no global regulator or supervisor and the national regulators and supervisors are still the predominant players for ensuring systemic stability.

Global markets suffer from weak governance and weak or missing institutions. There are no common standards, no global deposit insurance, no bankruptcy rules, no global anti-trust agency, no global lender of last resort, no global regulator and supervisor and no global safety net. The recent attempts to provide these institutions at the Eurozone level should be of interest to all of us. If they succeed in establishing and empowering the European Central Bank, European Banking Authority, European financial stability Fund etc. it would be of some relevance for the rest of the world.

G-20 was quite adept at coordinating actions following 2008-09 crises but there is still no serious movement about a multilateral regime that would be able to manage the interface among national institutions. There are many proposals for consideration as how to build better global economic governance for the future? The IMF may be assigned some role but it is not clear if the Bank would get a seat on the table.

There is, however, a serious danger that the pendulum may now swing too far in the other direction and many policy makers in developing countries may draw wrong lessons from this crisis. This may precipitate actions that may harm their economies. For example concluding that state should play a more interventionist role and therefore promote state owned banks and halt privatization of these banks would be stretching it too far. Yes, the regulatory and supervisory function should be strengthened, regulatory fragmentation and opportunities for regulatory arbitrage should be minimized, information disclosure, risk management and corporate governance in the private banks must be improved but the belief that the State owned banks provided stability to the system and were counter-cyclical is premature and may prove misleading. History cautions us about the dismal record of State owned banks in misallocation of credit.

Global financial crisis was caused, among many factors, by a set of precise incentives such as limited liability, excessive gearing, tax benefits for debt and government insurance. These are the factors that ought to be examined rather than encouraging the state to nationalize private banking institutions. The Bank along with the Fund have to carry out empirical studies to investigate the deeper causes of the Financial System instability so that they are able to develop the coping mechanism as well as preventive measures. Some observers feel that there has always been over focus on the last crisis but little reflection on what may precipitate the next crisis and how we should prevent it or manage it with minimum social loss.

1. Presented at the Conference on the Future of the World Bank and IMF held at Williams College, Williamstown on September 27-28, 2012 [↑](#footnote-ref-1)