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The purpose, management and governance of IFIs: A case study of ambiguity

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1. Introduction

The international economic order pursued by the Bretton Woods 'founding fathers' was based on the idea that a combination of different international institutions would be needed to keep the world financial system from degenerating into periodic and destructive crises (Mikesell, 1994).

Following the creation of the World Bank, a number of international financial institutions (IFIs) were established, sharing the Bretton Woods model as a means of achieving co-operation among lenders and borrowers and, at the same time, differing in regional orientation and modes of behaviour. The three regional development institutes - the Inter-American Development Bank, the Asian Development Bank and the African Development Bank - followed more closely the World Bank course. The European Investment Bank (EIB) and, much later on, the European Bank for Reconstruction and Development (EBRD), on the other hand, developed their own approach to international co-operation and development finance.

In all cases, IFIs seem to share a common core in terms of goals, business procedures and organisational culture. They have also increasingly become a network reflecting a broader consensus on 'proper' country policies. These include fiscal restraint, trade liberalisation, and autonomy of central banks.

While it may be argued that their present scope goes much beyond what was originally envisaged as their mission, investment financing remains the primary, explicit focus of their operations. Thus, it seems reasonable to ask how they have performed in this specific field and whether their presence as international lenders of last resort has been and will still be useful. The question, however, is not as simple as it sounds: IFIs possess a number of characteristics, from their quasi-public nature to the non-profit status, that make it rather difficult to establish performance standards. They have also come to behave as if they were given a mandate to supervise and discipline borrowers, be they countries or private parties. The resulting scenario is complex and needs to be explored with some care to avoid that the many, and potentially conflicting goals of these institutions pre-empt any serious evaluation of their capacity to match objectives and means.

2. IFIs as non-profit institutions

The non-profit status of IFIs can be partly traced to their inter-governmental nature and partly to the need to assume a posture of moral agents in pursuit of the public good of reconstruction, development and stability. Most of the early chronicles of the World Bank (e.g., Galambos and Milobsky, 1995), however, register a hard-nose, business-like attitude reflecting the weight of the Wall Street establishment on the organisation as well as the financing strategies of the institution. Indeed, all IFIs seem to be ambiguous about their non-profit status and their public nature, two characteristics that actually weaken their claim of being promoters of market freedom against the interference and, allegedly, the ineptitude of the public sector.

Market failures, such as asymmetric information and the fact that lenders might have incentives to shirk, could justify the existence of international non-profit institutions.

But what is the economic basis that might justify the existence of international 'non-profit' institutions and to what extent can it be utilised to understand the creation of IFIs as self-promoting, autonomous agencies? The main economic theory to this effect applies to the institutional sectors: last resort financing for current and capital account adjustment (Schwartz, 1992), investment for economic development (Gurley and Shaw, 1992), basic needs and social and economic reforms (Killick, 1995). In all these sectors, markets may fail because of asymmetric information (Anayiotos, 1994), and because lenders find that profit gives a powerful incentive to shirk. Shirking may consist of forcing conditions upon borrowers, and of lowering the quality of services provided by financial intermediaries (such as project preparation and supervision tasks). These activities, in fact, may be carried out in the interest of the borrower because the intermediary is individually sheltered from default by government guarantees.

Profit maximisation may also be construed to be inefficient because it may lead, in imperfect credit markets, to a failure to select projects with positive net present values as a consequence of agency costs, adverse selection and the redistributive nature of credit contracts under risk (Jensen and Meckling, 1986, Förster, 1995, and Horn, 1995). Senior lenders who maximise profits tend to capture the rents arising from the fact that the financing of new and less risky projects lowers the risks of all previously issued debts, while raising the cost of total debt to the borrowers. Financing of riskier projects, on the other hand, and its adverse redistributive effects on senior lenders, is generally prevented by the fact that most banks in developing countries reserve the right of recalling all loans if the creditworthiness of the borrower falls below what they consider a minimum acceptable standard.

The monitoring difficulties of development credit both from the point of view of the borrowers and of the lenders thus appear to justify the setting up of major non-profit agents acting as lenders of last resort and to monitor borrowers and other lenders' 'quality'. In this respect IFI loans can be considered a 'trust signal', as they indicate that the borrowers involved are creditworthy and that the possible co-financing lenders do not engage in arm-twisting with the borrowers; nor are they exposing the funds of their creditors to unsustainable risks.

The monitoring function can be enhanced by commitment mechanisms, which also act to increase the creditworthiness of the borrowers in the financial markets. Such mechanisms, envisaged since the very beginning of IFI operations, were pioneered by the IMF, and led to a form of extended conditionality, requiring the country on the borrowing side to commit itself to productive investment (Claessens and Diwan, 1990) and approved policy changes. This demanded in turn the development of policy prescriptions reflecting a broad agreement on 'good' government behaviour. The so-called "Washington Consensus" grew progressively from a broad and somewhat lose macroeconomic framework to include standards of market freedom, the importance of the private sector, trade liberalisation, credible exchange rates, sector policies, welfare systems, governance rules and, ultimately, the very functions of the government. Commitment to 'market friendly' policies was difficult to extract at first, in part because the totalitarian governments that dominated the development scene in the post-war period could not credibly commit themselves to actions which denied their nature. A combination of economic factors and political evolution, however, made it increasingly possible for governments to send their own 'trust signals' to the markets, thus validating, but ultimately also voiding some of the certifying tasks that the IFIs had usefully undertaken.

An additional reason that is sometimes cited as a major justification for the existence of IFIs and, indirectly, their non-profit status, is the provision of public goods. Among these, one can certainly put the trust-generating signals cited above, but also, at least in the intention of the founding fathers, a contribution to international liquidity and the efficiency of international financial markets. Compared to private transactions, the financial flows controlled by IFIs appear minuscule both in terms of money collected from the financial markets and money lent to countries and/or private borrowers. Nevertheless, a convincing case may be constructed that liquidity creation is not possible without a sufficient supply of information (see, for example, Drabek, 1995, and Zecchini, 1995, for a favourable account of the role of IFIs in mobilising resources for the development of transition economies) and, indeed, without trying to understand the very process of development (Stern and Ferreira, 1993). IFIs, therefore, through their advisory and consultative role, informed by their monitoring activities and backed up by extended conditionality, may be seen as the key providers of reliable information on world economic and financial conditions and, as a consequence, as major contributors to international liquidity (James, 1995, 1996).

More controversial public goods provided by IFIs are related to their functioning as a network for professional best practices and control on the quality of the projects financed. Since their inception, project evaluation techniques were indeed sponsored as a professional field and extensively used in practical work by IFIs, with special emphasis and enthusiasm by the World Bank. This had enormous effects on the popularity of project evaluation as a field of economic analysis as well as a professional tool. But IFIs themselves seemed to be ambiguous and somewhat unreliable about its use. Reviews by external bodies of IFIs concluded that guidelines for project evaluation were often ignored or misused. In several cases, projects were selected for political reasons and technical and economic evaluations were utilised ex-post only for cosmetic or bureaucratic purposes.

3. Accountability and governance

As non-profit institutions, IFIs enjoy widespread tax exemptions and are subsidised by member countries. Exemptions range from non-liability from capital taxation to limited liability from income taxation for officers and employees. Subsidies include those in kind, such as real estate, machinery and free personnel, but also financial subsidies such as the provision of capital from the shareholders without the expectation of dividends or capital gains. Member states grant further diplomatic privileges to IFI officers, immunities of various kinds, and housing and educational subsidies.

Against this background of exemptions, prerogatives and franchises of stakeholders (IFI managers, employees and bond subscribers), it appears natural to ask what rights are vested in the shareholders, as well as to whom and how the IFIs are accountable. The question is important, but by no means trivial to answer, for three main reasons. First, non-profit institutions, by their very nature, tend to be self-referential, in the sense that the absence of profits and the non-definition of residual rights practically voids ownership (Peters, 1993). Second, conflicts of interest and moral hazard may develop among member countries if borrowers behave opportunistically and count on being ultimately bailed out by the IFIs themselves from any massive debt crisis. Adverse selection and a fall of trust may also arise from lender behaviour, if IFIs let themselves be unduly influenced by the political preoccupations of major shareholders. Third, perks and empire building, the major source of conflicts between managers and shareholders in the modern corporation, may be especially insi-

dious. In fact, monitoring by IFI shareholders is generally lax, national bureaucracies tend to be subservient and some governments are known to try to use managers to pursue their own strategies.

Governance rules of IFIs are indeed difficult to pinpoint, because they were treated since the beginning as international bureaucracies in the UN-style, rather than as corporate entities. Boards are variously composed of central bank and treasury representatives, but they often appear to be themselves a mere extension of national bureaucracies. Annual meetings congregate central bank governors and ministers of member countries in largely ritual exchanges, whose main scope is often to look outside the institutions, to the world order and the international markets, rather than to IFIs' capabilities and performance. Debate on efficiency and effectiveness is discouraged and only sparingly taken up by legislators when the time comes to vote on appropriation bills for new capital injections. A combination of good personnel policies, sincere as well as strategic displays of goodwill, enlightened network building, public relations and straightforward lobbying keeps the IFIs' reputation sufficiently high in the right circles to ensure political support when it is needed. Decision-making procedures, technicalities and professionalism are sufficiently complex to appear to justify the lack of transparency, and the essentially unaccountable nature of much of the institutions' operations and managers.

Governance appears to be one of the major weaknesses of IFIs.

In sum, governance appears to be one of the major weaknesses of international financial institutions. To be sure, lack of definition of shareholders' rights on one side, and covert vesting of rights onto management and 'key' shareholders on the other, may have helped to free the organisation from the encumbrance of multilateral controls and costly active monitoring. At the same time, lower monitoring costs may be more than counterbalanced by higher costs of lobbying, public relations and the management of periodic re-organisations and related bureaucratic crises. They may also have resulted in lack of substantial support in the IFIs natural constituencies and possible allies such as NGOs and liberal groups of various kinds.

4. Hard noses and bleeding hearts

While similar to UN organisations as non-profit, co-operative enterprises among member states, IFIs have always eagerly emphasised their different nature of 'concrete' operators and market actors. This difference is reflected in their pragmatic approach to finance and development, as well as in their tough stance on the need to discipline borrowers. According to this view, the language as well as the operations of IFIs should be such as to ensure shareholders/creditors that their surveillance on the borrowers will make sure that the loans go to a good end. As a consequence, IFIs should be tough-looking and keep their distance from charities, NGOs and other 'do gooders'.

This has far-reaching consequences in shaping the behaviour of IFIs. On one hand, they do not do a good service to the UN organisations, which are seen as 'bleeding hearts' or the epitome of incompetence. On the other hand, a 'hard nose' posture may work well with weak governments who need help and legitimacy, but is an easily defused threat for governments under normal political and economic conditions. Imposing tough conditions on lending, ignoring the consequences of projects on income distribution, on the poor, on the environment and on other 'soft' components of society, has been widely practised by IFIs, but by their own account, this has proven to be highly counterproductive. Of course, 'talking tough' may be more effective and justified when it reflects the more recent "Washington Consensus", however, on the predominance of the markets tempered

by social sensitivity. Even in the best circumstances, however, it may risk to overstate its own case and lose the audience by an excess of confidence.

Yet one can find some merit in the presence of financial agents that act as advocates for the market, while at the same time take an interest in developing projects that the market would probably not consider for financing. 'Hard nosing' in this case can be seen as a strategy to gain reputation in the eyes of the other market players. Thus, IFIs can afford to finance riskier loans which venture into 'soft' areas such as institution-building, poverty alleviation and environmental protection, and at the same time, keep their high credit-rating and their market reputation. Because the combination of tough stance and soft operations corresponds to a basic ambiguity in their mission of suppliers of public goods, they can afford to appeal to the right and the left of the political spectrum. They may indeed make politically and economically palatable for the 'hard noses' the policies that the 'bleeding hearts' would fail to deliver for lack of resources and political support. The down-side of these considerations, of course, is that, as they strive to achieve market credibility, 'hard nosing' can fall in the trap of pursuing hard policies that hit the poor and worsen income distribution. At the same time, it may fail to do anything of substance for the more vulnerable segments of society (Sinha, 1995).

5. Targets and instruments

While all IFIs have stated purposes and clearly identifiable constituencies, their short-term targets are dictated by the interaction of very many interest groups.

IFIs pursue a variety of objectives ranging from development (e.g., the World Bank) to promoting integration, social cohesion and balanced development in Europe (e.g., the EIB). The interpretation of these objectives changes with time, as does the specific formulation of the targets that are indicated as having priority. Interest groups of various kinds interfere with target setting and often make the implementation of the institutions' objectives complex and unpredictable. While virtually all project IFIs can be denoted as long-term lending institutions with stated purposes and clearly identifiable constituencies, their short-term targets and instruments are dictated by the interaction of many interest groups, bureaucracies and governments. Indeed, the stated targets are often unrealistic. A case in point is the group of IFIs that is concerned with development aid, a field blessed by a multitude of interests ranging from legislative committees to commodity groups, industrial groups, and the various elements of the voluntary and intellectual community. The set of targets that results is often internally incoherent, and incompatible with the limited instruments available (Ruttan, 1996).

Yet, IFIs have proven to be quite effective, even though perhaps too much in "à la guerre comme à la guerre" fashion, to deal with the problem of finding a workable compromise between a conflicting set of goals and the set of feasible instruments. This is in part the consequence of the pragmatic approach that most of them have found inevitable to follow, and in part of the technical capabilities of staff and management. The lags involved in long-term projects, by making it difficult to recognise success and failure, have also made it easier for the pragmatists to constantly change course in response to the prevalence of this or that interest group. It is hard to say whether this flexibility is good or bad. It denotes a particular type of time inconsistency but, at the same time, a certain capacity to deal with the inherent imperfection of state contingent implicit contracts with multiple constituencies. In their role as policy advisers, for example, IFIs have maintained an overall balance between economic and political targets, thus favouring more democratic as well as more pragmatic approaches to government by consensus (Haggard and Webb, 1993).

In any event, the complexity of goals and instruments characterising the present status of IFIs does not appear by itself a sufficient reason to call for a simplification in their scope, structure and mode of functioning. The concentration on infrastructure or agriculture that was typical of the early stages of development finance, for example, can hardly be reproduced today. In fact, second generation development finance appears such a rich and intriguing phenomenon that IFIs may be too simple to cope with it through the limited array of debt instruments that can be mustered. More complex forms of financial institution are called for to operate in global security markets and to use to a fuller extent the capabilities of the new information technology (Geisst, 1988).

The re-organisation that is taking place in the banking sector, for example, shows that banking is becoming more diversified both at the industry and at the firm level, and it is augmenting both the scale of its operations and the variety of its products. Effectiveness in pooling resources from a multitude of savers is increasing and so is the capacity to finance projects on the basis of their merits rather than their guarantees. In this rapidly changing scenario, IFIs may seem ill at ease, because of their ambiguous nature as non-profit making financial institutions. Yet they have proven able to innovate, even within the narrow limits of their mandate as inter-governmental organisations (Diwan and Kletzer, 1992). In the case of project financing, for example, IFIs have been leaders in experimenting with a variety of forms and structures, and are being recognised as authoritative and competent in the field of financial engineering. A similar position has been gained in currency packaging to reduce foreign exchange risks to borrowers and lenders, and in the capacity to manage with success, a diversified portfolio of securities.

IFIs may to be too simple to operate in global security markets. More complex forms of financial institutions are called for.

The many accomplishments in innovating, however, are not enough to show that IFIs are effectively able to cope with the increasing complexity of world financial markets. Risk management and securitisation, for example, appear to be two areas where such conservative institutions, predominantly staffed with bureaucrats, economists and engineers, can hardly be expected to perform. The loan process, which has been traditionally the field of emphasis of IFIs, tends to crowd out the potentially creative activities of liability management. It also has the consequence of focusing the attention of the stakeholders on the more political side of the activities of the organisations. This only generates the lopsided need for the IFIs to keep 'moving the money' to satisfy the political constituencies and the need to deliver in the eyes of the shareholders, the commodity and industrial lobbies and the competitors in the development field.

A major negative allegation in this respect has come from the so-called North-South debate (Vos, 1996). IFIs have been accused to be instrumental in a 'loan-bunching' problem. This is a cyclical model where developing countries are alternatively treated with massive credit pushing and credit rationing. According to this model, IFIs would lead periods of credit pushing. Under the pressure of the oligopolistic financial markets where they operate, these institutions would easily find their 'money moving' urge leads to incentives to open the road to private international financing of an excessive amount of loans. In turn, this would cause an unsustainable build-up of foreign debt in Southern countries with an ensuing financial crisis followed by a period of credit tightening (Suter, 1992) and a reverse flow of resources between the South and the North. No special leadership would be provided by IFIs in this more difficult phase of the cycle. Some empirical support of this view can be found in the endorsement of the World Bank for large scale borrowing as late as 1981, and its subsequent lagging role in the debt-reduction process (Armendariz de Aghion and Ferreira, 1993).

6. The people and the work

Compared to all other financial institutions operating in the international markets, IFIs stand out for the quality and diversity of their staff. Highly educated, relatively youthful, culturally and ethnically diverse, the IFIs' personnel appear to strike standards unequalled by most comparable institutions, including the UN and the central banks. Against this background of capability and potential excellence, however, the IFIs' staff has shown a rather mixed performance. Many studies and staff reviews have recognised that the quality and the rich background of those attracted to IFIs has been under-utilised or misused. Management practices designed to pursue abstract goals rather than responsibility have stifled creativity and encouraged careerism and opportunism rather than personal and professional growth. Creativity has also been low, while the long lags in recognising successes and failures have made a mockery of the claim of the institutions to encourage innovative behaviour and reward independent thought.

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The non-profit nature of IFIs and the ensuing ambiguity on goals leads to confusion among explicit and implicit objectives. The political context is played down as a framework for generating explicit goals, but, at the same time, it looms large in the unspoken explanation of the underlying motives to almost everything that goes on from loans to staff careers. In turn, this engenders cynicism, passivity and self-doubt. The resulting working environment is one where there is a tremendous fear of those innovative actions that may result into leaks, errors, or simply political fallout of one type or another. In this context, cautious behaviour is at a premium. Many people are pushed to focus on their career rather than on their work in spite of the widespread practice of politically appointing top-level managers and executives and ladder-climbing by affiliation. In sum, the IFIs' work environment is a case study of ambiguities and stress, where professional excellence often goes hand in hand with alienation, and idealism with lack of purpose.

7. Conclusions

In many ways the IFIs of today are very different creatures from the institutions created or envisaged at Bretton Woods. From a model of restrictive intervention, active monitoring and government financing, IFIs have evolved towards a diversified set of organisations by and large market-friendly, private-oriented, liberal and independent. The economic model of the IMF has been vindicated by events (Polak, 1997), and has been embraced by virtually all other IFIs. However, in spite of their influence and the success of this model of economic policy, IFIs are not much liked by the general public, by their development constituencies, or even by their staff. Governance rules are opaque and objectionable. Political and ideological standing appears to be ambiguous and often opportunistic. Given their nature, which at best can be characterised as an unanticipated good effect of a bad idea, what should be their future?

First, one should recognise that IFIs have given good proof as instruments of co-ordination in imperfect capital markets. There is really no reason why these functions should not continue to be performed in the future by IFIs, displaying the prudence and the competence that they have shown in the past.

Second, some evidence suggests that IFIs may have used their position to administer questionable principles and to dispense equally questionable advice. The extent to which these practices may

have caused a real damage to the countries is unclear. However, this highlights the question of responsibility and governance. To whom should these institutions be accountable? And what should be the criteria to judge success and failures, establish responsibilities, and discriminate between legitimate beliefs and manipulative ideologies? Here, a better, more skilful and clearer institutional design is in order. The new design should give greater consideration to the need to align ownership and control, and to balance the rights of all stake-holders (managers, staff, lenders and borrowers) in making decisions about the broad strategies of the institutions. This applies equally to the choice of operations, information and external relations.

Second generation IFIs should monitor borrower performance across a broad variety of projects rather than lending for projects that they have chosen and designed themselves.

Third, whether IFIs have been successful in project lending appears doubtful. Reviews of projects financed by IFIs have not revealed marked differences from other projects financed by governments or private banks. Also, many studies of IFIs' operations have shown that decisions to lend were often loaded in favour of ruling elites and bureaucratic counterparts. Decisions also tended to be taken under the pressure of short-term motivations rather than dictated by long-term needs or by sound allocative criteria. Second generation IFIs should thus direct their resources to monitor borrower performance across a broad variety of projects essentially chosen by governments and/or private parties. They should not engage primarily in lending for projects that they have chosen and designed, or try to impose lending plans to member countries.

Finally, in spite of their professional quality and the excitement and prestige of their jobs, IFIs' staff have often been operating under difficult and unyielding conditions. They have felt alienated by a too sterile and hierarchical organisation, by their lack of real responsibilities and, often, by the antagonism of non-governmental organisations and other interest groups. A new wave of international financial institutions can only be successful if they are able to offer to a sufficiently large number of dedicated people the unique professional opportunity to work effectively for development and the improvement of the international community.

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