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A Larger Role for the Regional Development Banks

With their 43 % share of total lendings by the multilateral development bank system (1994-1998), the African, Asian and Latin American development banks have become heavyweights in regional development financing. They were established to exploit regional specialization advantages, but have so far been only partly successful in this respect. In various areas they also continue to lag behind the World Bank in innovation and efficiency.

In the debate on their future role the regional banks have established long-term strategies in response to growing private capital inflows, globalization and new challenges to development cooperation. To solve the overriding problem of the parallel structures of the World Bank and regional banks, the leading actors are now looking to increasingly radical approaches: a) de facto fusion through comprehensive harmonization, coordination and cooperation, the option favoured by the banks themselves, b) delinking through the regional banks' general withdrawal to complementary niche functions and c) the World Bank's withdrawal first from Asia and Latin America and later from Africa, as proposed in the Meltzer report.

Despite a number of advantages, all three options are, on the whole, suboptimal because they essentially amount to replacing the cost and inefficiencies of overlapping with the cost of monopolistic structures. A more promising approach would consist in applying the competition principle and using the existing parallel structures to make the development bank system more dynamic. Within an efficient framework for regulating competition parallel structures are, after all, less a cost factor than a requirement for improved resource allocation, a driving force for conceptual and operational innovations and the basis for diversity and choice. A regulatory framework of this kind should make competition possible where it is superior to an administered division of labour as a means of allocating development cooperation resources and prevent competition where the aim is harmonization and coordination in the interests of low transaction costs; it should also ensure that both the development banks – through the abolition of the "preferred creditor status" as a general principle, for example – and the developing countries assume responsibility for the risks associated with lending. Finally, it should optimize the interface with private capital suppliers by applying the principle of subsidiarity and ensure that the development banks act as catalysts of private funding by taking a dynamic view of this principle. The better partner countries and regional banks responded to market requirements, the more efficient a regulatory framework would be.

If they are to operate successfully in a competition-oriented development bank system, the regional banks must actively improve their core skills in the areas in which they derive comparative advantages from being close to regional realities. This is particularly true of the following priority areas: regional cooperation and integration, governance and regional crisis and conflict management.

In giving itself a more distinct profile in the regional banks and in its collaboration with them, German government development cooperation should also focus on these areas, which are consistent with its strategic priorities or comparative advantages. It should also commit itself to reinforcing the principle of competition in the development bank system and so launch a process of rethinking in the bodies concerned. In addition, it should help to improve the regional banks' competitiveness by supporting the decentralization efforts, for example. It might also do more to seize the opportunities to acquire a more distinct development policy profile through earmarked trust funds, special facilities for training schemes, for example, and other such options as research consortia.

The Regional banks in the multilateral development bank system

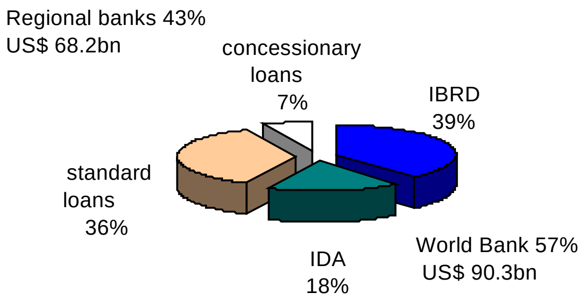
The African Development Bank (AfDB), the Asian Development Bank (AsDB) and the Inter-American Development Bank (IDB) were established in the 1960s and 1970s to exploit regional specialization advantages. This expectation stemmed primarily from the greater self-determination that resulted from regional member countries holding a majority of the voting rights and shares in their bank and providing most of its staff, which it had been hoped would bring them closer to regional realities and so make for greater ownership and autonomy, more appropriate problem-solving approaches, projects and programmes and so greater efficiency throughout the development bank system. Even though this has been only partly achieved to date and in many respects what have emerged are essentially regional copies of the World Bank, which are, however, unable to emulate its innovative dynamism and efficiency in various areas, the regional banks have become heavyweights in development financing. In the five years from 1994 to 1998 they accounted for a total of 43 % of lendings by the multilateral development bank system, although the figure varied widely among the three regions: 32 % in Africa, 37 % in Asia and as high as 57 % in Latin America. The relative importance of concessionary loans was greatest in the case of the AfDB, followed by the AsDB and the IDB. However, compared to IDA lending, the World Bank's soft window, they played a subordinate role.

Debate on the future role of the regional banks

The debate on the future role of the development banks is gaining in intensity. Since the mid-1990s the banks themselves have been seeking an answer to the challenges posed by rapidly growing private capital inflows into developing countries, the consequences of globalization and changing demands on development cooperation by drawing up comprehensive long-term strategy papers. The parallel structures of the regional banks and World Bank have come under scrutiny at least since the 1996 "Task Force Report on Multilateral Development Banks".

Nonetheless, given the "institutional weight" they now carry and a broadly based "political guarantee of existence", the regional banks are not at present seriously

Total lending by the multilateral development banks in Africa, Asia and Latin America, 1994 - 1998



Source: OECD 1995 -1999, World Bank 1995 -1999

questioned. This special guarantee of the regional banks' future existence arises mainly from the considerable interest in the leverage effect of regional ownership on development, which is based *inter alia* on the regional majorities on the banks' boards and among their staff, on the foreseeable damage to foreign relations if the regional banks were to suffer radical cutbacks, which would be seen as a sign of waning solidarity, and on the particularist geostrategic interests of major G7 countries (the USA, Japan and France).

If, then, the existing parallel structures cannot be touched, it is all the more important to achieve a lasting increase in what is generally regarded as the inadequate value added to development of the current juxtaposition of the World Bank and the regional banks. In the debate, in which radical solutions are increasingly being considered, three basic options for optimizing the multilateral development bank system have essentially emerged: the banks themselves would like a kind of de facto fusion through wide-ranging harmonization, coordination and cooperation. The second option, an approach to which can be seen, for example, in the latest AfDB strategy "A Reinvigorated Bank – An Agenda for Moving Forward", published in 1999, advocates delinking through the regional banks' general withdrawal to complementary niche functions. The third option is the World Bank's withdrawal first from Asia and Latin America and later from Africa, as proposed in the Meltzer report.

Superiority of an efficient framework for regulating competition in the development bank system

Although all three options not only pose major problems where the detail is concerned but also have a number of advantages, they represent, all in all, suboptimal approaches to solving the problem of the parallel structures of the World Bank and the regional banks. They essentially amount to replacing the cost and inefficiencies of the overlapping of structures and activities with the cost of monopolistic structures. A strategy that seeks to streamline the existing parallel structures in the development bank system not at any price but by applying the idea of competition, using these structures to ensure the further dynamic development of the system, seems far more promising. In an efficient framework for regulating competition, after all, it is not so much the cost of parallel structures that is decisive as the economically more relevant increased cost-benefit ratios resulting from improved resource allocation. Parallel structures can become the driving force behind conceptual and operational innovations and the basis for diversity and choice. The growing convergence of paradigms, ideas and best practices is not an indication that competition in development policy has now become superfluous owing to the absence of other options. For one thing, it very much reflects a quasi-monopoly of Anglo-Saxon policy models; for another, where development policy models are concerned, major challenges persist owing, among other things, to the new communication and information technologies. Again, when it comes to giving problem-solving approaches practical shape, relevant options continue to compete. Competition is, after all, still the most effective policy for preventing the political instrumentalization and corruption of the banks, always a potential consequence of their otherwise desirable closeness to their regions.

An effective framework for regulating competition in the multilateral development bank system must above all perform the following functions and meet the following requirements:

– It should make competition possible wherever development banks or donors are able to convert their comparative advantages into innovative ideas, new areas of business and "bankable" products, and it should prevent competition where harmonization, coordination and cooperation are essential because of the developing countries' interest in low transaction costs and transparency.
– An efficient regulatory framework is, however, in no way inconsistent with donor coordination and such concepts as the "Comprehensive Development Framework". It is rather a necessary complement to them because it provides criteria for identifying areas in which the harmonization of norms and standards, cooperation and coordination are more efficient and also permits the definition of areas in which competition-based diversity and choices indicate the likelihood of more favourable cost-benefit ratios. In other words, it is ideally the guarantor of an optimum blend of competition-related allocation on the one hand and harmonization, coordination and cooperation on the other.
– An efficient regulatory framework must set standards and norms which ensure that competition is efficient. Environmental, social and technical standards that prevent a race to the bottom among the multilateral development banks in particular and the donors in general must, of course, exist, and they must be observed.
– If competition is to have the effect of promoting efficiency, there will need to be an improvement both in competence, know-how and professionalism on the part of the partner countries, so that they are able to evaluate the various options appropriately, and in the regional banks' competitiveness vis-à-vis the World Bank.
– Competition in the development bank system will increase the efficiency of allocation only if the banks on the one hand and the developing countries on the other assume responsibility for the risks associated with lending. In the future the banks should bear the full credit risk of their lending, cover any losses from profits or equity capital and, to this extent, forgo their preferred creditor status. This should not apply, however, where the donors provide guarantees and/or subsidies – not as ad hoc measures but as strategic decisions of principle – because they want to see funds going to certain projects or countries, support for which is meant to supply "public goods", examples being anti-AIDS programmes, climate protection and poverty reduction in the HIPCs. The overall result would thus be a kind of selective preferred creditor status. The assumption of credit risks by the partner countries too would do a great deal to increase selectivity in the demand for the development banks' resources and so refute the argument that the competition principle does not apply under the conditions of essentially unlimited demand from the developing countries. Accordingly, even in the case of the poorest

countries debt cancellations should not lead to the complete writing off of foreign liabilities, as the Meltzer report, for example, suggests, but merely to the restoration of a tolerable debt service burden – along the lines described in "The Indebtedness of the Developing Countries" (GDI Briefing Paper No. 2/1999) – to make it clear that the countries concerned are prepared to subscribe to the principle of ownership and accept responsibility for their financial obligations.

– A regulatory framework must also regulate the relationship with private sources of capital. As a general rule, this aspect is governed by the principle of subsidiarity, according to which projects should not be publicly financed if private resources are available for the purpose. When interpreted dynamically, the subsidiarity principle requires that the development banks act as catalysts and forerunners of private funding. One aim should be to open up new areas of business – example: projects in the area of crisis prevention – in such a way that they become "bankable" and money can thus be made in them. Another aim should be to help improve the partner countries' creditworthiness, through a gradual adjustment of loan conditions to their growing debt service capacity in accordance with the "graduation" principle, for example. It is equally important for the interface between public and capital market resources not to be arbitrarily attached to certain revenue thresholds of the recipient countries but, in compliance with market economy principles, to be determined in competition. The development banks might, for example, charge newly industrializing countries fully for both their financial and their advisory services and then let the market decide whether, for instance, a commercial bank is able to offer the service required at a lower cost in collaboration with a consultancy.

Future priorities

If they are to be able to find their proper position in a multilateral development bank system whose efficiency is to be increased by a satisfactory framework for regulating competition, the regional banks must actively improve their core skills in the areas in which they have comparative advantages. This is particularly true of areas of policy in which the exploitation of their closeness to regional realities promotes the "Africanization" of the AfDB, the "Asianization" of the AsDB and the "Latin-Americanization" of the IDB. However, comparative advantages do not form on their own: they are the outcome of long-term policies, i.e. they require the development of an appropriate strategy. Thus the regional banks' potentially greater proximity to their regions leads to comparative advantages only when the regional networks are cultivated and, to some extent, formalized and regional know-how is systematically recorded, analysed, kept up to date, appraised and converted into policy advice and financial services. The resulting priority areas need, moreover, instrumental and institutional foundations.

The most important priority areas, which all three regional banks can and should expand, are regional cooperation and integration, the whole sphere of governance and regional crisis and conflict management. The promotion of regional cooperation and integration is one of the core tasks defined in the regional banks' statutes. Although there are interesting approaches in this respect in Latin America and, to some extent, Asia too, not enough has so far been done to tap the potential for welfare-generating and peacemaking effects. The assumption of a leading role in the financing of cross-frontier projects and programmes and the agreement-based promotion of integration processes through research, concept development, discussion fora and information networks might strengthen the regional banks' catalyst function significantly and lay the foundations for them to act as the "integration banks" of, say, the MERCOSUR, ASEAN and SADC in much the same way as the EIB operates on behalf of and as trustee for the EU.

Of particular relevance are the advantages to be gained from involvement in governance-related areas of the development banks' activities relating, for example, to projects designed to modernize the state and to promote civil society. In such cases they create enhanced opportunities for involvement in sensitive local issues and make for greater familiarity with – in the broadest sense – autochthonous peculiarities (value sensitive projects, cultural sensibilities), which enables systematic account to be taken of ethnic, tribal and cultural traditions, sensitivities, potentials and constraints. This is not confined to the official policy dialogue. The aim is rather the continuous high-level involvement of local regional bank representatives in the member countries' political and civil networks, in which, as mediators, catalysts, arbitrators and, in some cases, players, they have greater opportunities for the participatory shaping of relations with their clients than the World Bank. The *conditio sine qua non* in this context is effective decentralization of the decision-making, negotiation and allocation procedures, because continuous participation in highly complex processes cannot occur within the framework of short-term missions. As evident from the proportion of loans going to the subsector comprising the state and civil society, which is particularly governance-related, the IDB, AsDB and AfDB have already begun to focus on this area, resulting in its carrying more weight in the overall portfolio in 1998, or in 1997 in the IDB's case, than at the World Bank, for example.

The systematic development of core skills in the governance sphere is necessary not least because of the danger of economic, political and military crises and conflicts eroding the foundations of banking and destroying successful projects on a large scale unless the regional banks play a key role in regional crisis and conflict management. This concerns both countries affected by national and global financial crises and countries afflicted by war and civil war. Against this background, the development of a wide range of services for promoting "structural stability" is essential. It must include measures and policies both in the area of crisis prevention and in the areas of crisis and conflict limitation and the stabilization of peace processes. The contribution that the regional banks can make to crisis management is, of course, confined to their performance of a catalyst function.

Multilateral development bank projects for the promotion of state and civil society, in % of total lendings

	1997	1998
World Bank	18.1	4.5
AfDB	5.3	15.1
AsDB	2.9	23.2
IDB	24.4	37.9

Source: OECD, Development Co-operation Directorate, Reporting Systems Division, 1998 – 1999

Options for German government development cooperation

The strategic options for giving German government development cooperation a more distinct profile in the regional banks and in the collaboration with them must fit into this system of coordinates for regulatory, thematic, institutional and instrumental guidelines relating to the positions to be occupied by the AfDB, AsDB and IDB in the future. The value added by the closer and diversified cooperation with the regional banks that would result in no more than relatively minor changes in the BMZ budget would be significant in the longer term. German government development cooperation would be increasingly seen by regional member countries as collaborating with *their* bank, having hitherto been largely perceived as one of the World Bank's partners and stakeholders. It could use the greater, or potentially greater, ownership for a broad range of cooperation projects, which have a high priority in German development policy, examples being activities in the areas of governance and conflict management. And it would increase the role of the regional banks in the development of their respective continents, improve the conditions for regional ownership and so strengthen the multilateral development bank system as a whole. This presupposes, however, that the frequent bias towards the World Bank in the past gives way to a more open attitude and that joint projects (co-financing, joint ventures) are sought with the regional banks in the future in line with the recommended priorities.

Given the overriding importance for the multilateral development bank system of an efficient framework for regulating competition, Germany should press for the reinforcement of the competition principle and, by mobilizing possible allies among the donors, major recipient countries and the regional banks, launch a process of rethinking. In addition, support for an improvement in the competitiveness of the regional banks should be increased, primarily through the promotion of a quality offensive with a broad impact and suitable offers of cooperation in the systematic exploitation of comparative advantages. It is particularly important to help them to consolidate their decentralization efforts, since the transfer of decision-making and implementing powers to their representatives in the partner countries is essential if the quality of their financial and advisory services is to be sustainably improved, the problem-solving options are to become more transparent and the unwanted and hitherto often chaotic competition among the donors is to be brought to an end through effective local coordination.

German government development cooperation might also take greater advantage of the wide range of opportunities for focusing on specific aspects of development within the regional banks and also in joint ventures with them through appropriate trust funds, facilities (for the development of early warning systems in the areas of environment and conflict management, for example) or other arrangements (e.g. "research consortia" to support research projects of special regional interest). Most other bilateral donors have long been doing this, enabling them to attain a far more distinct development profile than Germany, with comparatively limited resources. The particular leverage effect of such instruments also justifies the financing of special contributions that tend to be marginal in volume but extremely relevant in their impact, in addition to the regular contributions to capital increases and replenishments.

An active part should also be played in close collaboration with other donor countries in the development of the regional banks' core skills in the area of crisis and conflict management. This is consistent with the regional banks' potential comparative advantages in what is for them a crucial area, and it is consistent with one of the Federal German Government's foreign and development policy priorities. Possible starting points are the development of regional conflict research centres or of instruments for assessing the consequences of conflicts and the establishment of regional organizations for security and cooperation on the model of the OSCE.

Finally, cooperation and integration among the regional member countries should be promoted in the regional banks and in collaboration with them. Germany has gained some relevant experience in this sphere from both European integration and its own reunification and benefited from the effect that integration has of promoting welfare and ensuring peace. Close collaboration with the EU would be advisable in this sphere, since it has special competence in the promotion of regional cooperation and integration through development cooperation.

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Additional readings

Kampffmeyer, T. (2000): A Larger Role for the Regional Development Banks, GDI, Berlin (forthcoming)

Meltzer, A., et al. (2000): Report of the International Financial Institution Advisory Commission, http://phantom-x.gsia.cmu.edu/IFIAC/Report.html

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