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NATIONAL SECURITY COUNCIL
WASHINGTON, D.C. 20506

VIII (5).

INFORMATION

March 14, 1986

MEMORANDUM FOR JOHN M. POINDEXTER

THRU: STEPHEN I. DANZANSKY sid

FROM: STEPHEN P. FARRAR spf

SUBJECT: IDB Replenishment

Negotiations on replenishment of the Interamerican Development Bank (IDB) begin next Thursday, March 20, in Costa Rica. Treasury will be taking a tough position. A substantial funding increase -- within USG budget planning ceilings -- would be contingent upon:

-- Reform in lending policies (conditionality, faster-disbursing loans);

-- Reorganization of the IDB, including a new unit (headed by an American) to implement the new lending policies; and

-- Changed voting rules to require 65% of votes for a majority instead of the current 50% (allowing the U.S. plus one other donor to block proposals).

The changes are necessary if the IDB, long one of the least efficient of the multilateral development banks, to play a serious role in implementing the Baker Plan for resolving the third world's debt crisis.

Preliminary soundings indicate that the IDB and Latin governments are prepared to accept tougher conditionality and reorganization of the IDB. Their positions on the voting change are less clear. Between now and March 20, the Latins are likely to test whether the USG is unified behind Treasury's position. A display of unity is extremely important now. State appears to be firmly on board.

Philip Hughes concurs.

New File: VIII (I)
Regional Development Banks.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

JAN 08 1986

Dear Steve:

As Secretary Baker indicated in Seoul, we believe that the Inter-American Development Bank should play an active and important role in the "Program for Sustained Growth". However, to play such a role the IDB must undertake some fundamental reforms in conjunction with its Seventh Replenishment.

In preparation for the IDB replenishment, we have drafted the enclosed strategy and objectives paper. I would welcome your views on the approach and proposals that we have outlined in the paper.

Sincerely,

David

David C. Mulford
Assistant Secretary
International Affairs

The Honorable
Stephen I. Danzansky
Special Assistant to the President
and Senior Director
International Economic Affairs
Room 365
Old Executive Office Building
Washington, D.C. 20503

Enclosure

INTER-AMERICAN DEVELOPMENT BANK:
STRATEGY AND OBJECTIVES PAPER
FOR THE SEVENTH REPLENISHMENT

OVERVIEW

The Seventh Replenishment of the resources of the Inter-American Development Bank (IDB) will cover lending for the four calendar years of 1987-90. Formal replenishment negotiations are not scheduled to begin until March 1986. However, preliminary informal conversations among senior Treasury, senior IDB management and the four major Latin debtors (the IDB's "Group A" countries, Argentina, Brazil, Mexico and Venezuela) will be held January 13, 1986.

A series of fundamental reforms must be implemented as a part of the Seventh Replenishment of the Inter-American Development Bank (IDB) if that institution is to play the role we envision for it in the "Program for Sustained Growth." Overall, we seek:

- A charter amendment to change the majority needed for decisions from 50 percent (which gives the Latin borrowers, with a 53.5 percent share by charter, a veto) to 65 percent of total voting power (just shy of veto power for the U.S., with a 34.5 percent share by charter).

- Well targeted and conceived project lending within the context of country programs with appropriate conditionality.

- Organizational and personnel changes to enhance the effectiveness of the institution and to help ensure the policy changes are implemented.

- As part of the IDB's 1987-90 lending program, the introduction of a program of well defined, well targeted, fast disbursing non-project loans, initially piggy-backed to IBRD structural adjustment/sector loans.

In addition to these reforms, we will also seek to enhance the participation of the other IDB donor countries (Canada, Japan, and Europe).

If our approach is adopted, we would a seek substantial replenishment of IDB resources that is fully within the MDB out-year planning levels included in the FY 1987 budget submission. However, in the absence of reform, we must be prepared to withhold our support for the replenishment, even if it means an interruption of some duration in IDB lending.

STRATEGY FOR JANUARY MEETING

At the January meeting, the U.S. will express our continued support for the IDB and our desire to have the Bank play an active role in implementing the policy and financial aspects of the debt strategy. To do so, however, fundamental changes in the Bank's policies, procedures, organization and personnel will be required.

Our presentation and approach will be geared to convince the Latins that it is in their interest and the interest for the future of the Bank to work with us in adopting and implementing the reforms we have in mind. Absent these reforms, we will make clear to the Latins that the alternative is a very small replenishment and/or that we are willing to extend the negotiations into 1987 even if it means some interruption in the Bank's lending program.

We will also indicate that if together we can achieve a high degree of success, we could envision a substantial replenishment of IDB resources, including:

- An increase in the lending program for all four IDB country groups; and

- As much as 20-25 percent of this overall IDB lending program in a fast disbursing, non-project loans.

REFORMS

#1: Change in Voting Majorities

Under the IDB's current voting structure, the borrowing countries maintain a technical voting majority (53 percent), although in day-to-day operations the United States has enormous influence which allows it to serve as a partial counter-weight. By comparison, in both the World Bank and the Asian Development Bank, the donors maintain both a voting majority and actual control.

We need to alter the voting majorities on loans and policies to give greater weight to donor country views:

- We seek a middle ground on the voting majorities somewhere between the existing control which the borrowers now enjoy and a U.S. veto. (The U.S. now has a veto in the IDB's soft window.)

- We propose a 65 percent special majority (just shy of veto power for the U.S., with a 34.5 percent share by charter).

- This means that the U.S. Director plus any one other Director would have the power to veto loans and policies. (The other donors have three Directors.) We hope that this, along with the increased non-regional presence in key personnel slots, will stimulate the other IDB donors to be more active players.

- This would not require a change in the percentage of shares the IDB Charter stipulates the Latins must hold. However, it would involve amending the Charter to change the requisite voting majorites.

#2: Project/Program Loans

Concrete measures must be taken to address the IDB's weaknesses in the key area of policy conditionality and loan quality:

- The Governors' replenishment document must contain a new IDB policy statement stipulating that the Bank will scrutinize macro-economic, structural and sectoral policies relevant for project/program success and require appropriate policy conditionality before approving loans. In addition, IDB Management will be directed to cease disbursements when a borrower falls out of compliance with the agreed conditionality.

- We should also secure agreement that country strategies analyzing borrower policies and policy objectives, including a systematic consideration of enhancing the role of the private sector, shall be prepared or updated annually and will be reviewed (in summary form at least) by the Bank's Board.

- Rigorous internal project review must be undertaken to ensure that projects which violate IDB's own policies or have serious design flaws do not come to the Board for approval. Similarly, an ongoing evaluation process must ensure that borrowers are adhering to the agreed conditionality.

#3: Organizational/Personnel Changes

Bearing in mind that the IDB may readily agree to language for these changes but circumvent that language in actual operations, we need organizational and personnel changes to help ensure that the policy reforms we seek will be implemented.

- As currently organized, the IDB has no internal entity that is strong enough to insist upon quality/ conditionality even if it means not meeting lending targets.

- Therefore, we seek to merge two existing departments to create a counter-weight to the Operations and Project Analysis departments (which currently run the IDB).

- The new department will play a lead role in ensuring that projects are integrated and consistent with overall country strategies. It will conduct country studies and set priorities for country and sector work and conditionality. The department will have to sign off on every loan coming to the Board for consideration.

- Non-Latin individuals must be placed in key management and senior specialist positions.

#4: Fast Disbursing Loans

We believe such reform of the IDB would enable it to begin a well targeted, well defined program of fast disbursing loans in January 1987, the start of Seventh Replenishment lending. Such fast disbursing loans could constitute as much as 20-25 percent of overall IDB lending program during the four years of 1987-90.

Conditionality must be attached to non-project lending. The Governors' replenishment document would stipulate that:

- Since the IDB would need time to gain experience in fulfilling its new mandate, IDB non-project loans would initially be linked to the conditionality of a World Bank structural adjustment loan or a series of sector loans.

- The IDB non-project loans would contain conditionality imposed by IDB itself when the IDB demonstrates its ability to conduct and implement policy conditionality with borrowing countries. The IDB Governors would decide when this point had been reached.