

THE WORLD BANK BORROWING PROGRAM
INFORMAL SEMINAR - DECEMBER, 1979

Introduction

I would like to talk about several matters this afternoon--and keep this seminar as informal as possible. I do not have a prepared text. The purpose of the seminar is to provide some background for the paper before you on the Bank's lending rate, and more generally, to describe our borrowing program and the Bank's related policies. Accordingly, I would like to put our borrowing program in some frame of reference. Specifically, I would propose to discuss the following:

First, how is the overall borrowing program, not just for this year but for future years, determined? Second, are the financial requirements of the Bank predictable? What is the relationship of our borrowing program to our liquidity policy? Third, why has there been a tendency to recommend that we borrow sooner rather than later? In that connection, how does uncertainty play a role in deciding when we should borrow? What is the nature of the uncertainty? How important a factor are interest or exchange rate forecasts in deciding when to borrow? What do we do if markets become unstable for a while? Fourth, I would like to describe the major elements which the bond buyer looks at in deciding to buy our bonds. What is it that enables us to sell bonds? Fifth, I would like to take just one of those elements, out of many--the Bank's net income, since that is the matter which you will be considering in connection with the Bank's lending rate--and talk about the bond buyer's perception of our income and its relevance to him. In that connection, I would like to talk about the lag effect of changes in the lending rate and the effect of our borrowing costs and the return on our liquidity as it affects our current income.

Then I would like to conclude with some general comments about such matters as the maturities of our borrowings, Eurodollar markets, SDR's and similar points which have come up from time to time.

Finally, my colleagues--and you see practically all of the staff engaged in borrowing operations here--are prepared to discuss the current status of the markets in which we are borrowing or might borrow in the future. I have even suggested that they be prepared to predict interest rates 1 month, 3 months, 6 months, 1 year and 2 years from today for bonds with varying maturities from 2 to 20 years and at probabilities 1 in 2, 1 in 4, and 1 in 10 degree of certainty--and, of course, to do the same for exchange rates. I would prefer to leave the room during that exercise! Hopefully after I have finished the presentation and answered questions with their help, you won't consider those predictions all that relevant.

Let me start by apologizing if I sound too much an advocate or an adversary --its an occupational hazard, and I apologize in advance.

CONSTRUCTION OF BORROWING PROGRAM

The borrowing program, for the most part, simply reflects the Bank's cash requirements, i.e., the difference between what comes into the Bank in a particular period versus what goes out. The table below sets forth the main elements.

IBRD: BORROWING REQUIREMENTS
(\$ million)

	<u>FY80</u>	<u>FY81</u>	<u>FY82</u>	<u>FY83</u>	<u>FY84</u>
<u>Applications</u>					
Loan Disbursements	4710	5423	6335	7208	8128
Debt Retirement	2818	2792	3157	3735	3557
Payment to IDA	170	66	66	129	135
Other	<u>1224</u>	<u>7</u>	<u>160</u>	<u>175</u>	<u>192</u>
Total	8922	8288	9718	11247	12012
<u>Sources</u>					
Net Income	512	572	576	632	695
Loan Repayments	1028	1358	1780	2239	2565
Capital Subscriptions	170	158	258	700	700
Other	<u>1434</u>	<u>-33</u>	<u>143</u>	<u>143</u>	<u>160</u>
Total	3144	2055	2757	3714	4120
Cash Gap	5778	6233	6961	7533	7892
Next 3 yrs' Borr. "Requirement"	20727	22386	24877	26763	28808
Rephased Gross Borrowing	5300	6500	7700	8300	8800
Liquid Holdings	8937	9204	9943	10710	11618
Change In Liquid Holdings	-813	+267	+739	+767	+908
Liquidity Ratio	43%	41%	40%	40%	40%

In FY80 for example, the major uses or outflows of funds are loan disbursements --\$4.7 billion, debt requirements--\$2.8 billion, IDA transfers--\$170 million. The major sources of funds are loan repayments--\$1 billion; net income is projected at \$512 million. Paid-in capital subscriptions are \$170 million. The four main items --loan disbursements and debt requirements on one side and net income and loan

repayments on the other--represent the basic components of the Bank's cash flow (the large amounts of "Other" in FY80 are merely accounting entries to reflect the exchange adjustment on the non-dollar portion of our assets and liabilities and have no relevance to our cash flow).

The gap as you will observe is approximately \$5.8 billion in 1980. Stated another way, if we did not borrow in FY80, our opening liquid balance would decline from a FY79 closing balance of about \$9.5 billion, by \$5.8 billion, or to \$3.7 billion.

Virtually all of these cash flow elements are contractual or highly predictable in a particular year. The paid-in capital relates to the 10% payment on the recent Selective Capital Increase. The loan repayments are made under amortized schedules which are fixed. Even the net income, while technically not contractual and not therefore fully predictable, has components which are predictable--the interest rate on outstanding debt, the interest on loans, commitment fees, and administrative expenses. Even the major outflow--loan disbursements--is in a sense contractual. With respect to these disbursements, it is unlikely that loan disbursement projections over several years will be off by more than 5% and, even if greater, certainly not of sufficient size to affect to any significant degree the resource gap. Our debt requirements are obviously fixed and predictable since the profile of our debt structure is not likely to change in the near term. Payments to IDA reflecting transfers are reasonably predictable.

Nor is it difficult to calculate these elements for the next several years in advance. The cash flow, over a three-year period, will reflect disbursements in process from commitments already made. Our debt servicing profile is known for the next three years.

We calculate the resource gap for the next three years and cumulate it. As you can see, the cumulative gap (excess outflow over inflow) for the next three

years (FY81-83) will be \$20.7 billion at the end of FY80. Bond buyers will have to supply those resources. At the end of FY81, the gap will be \$22.3 billion for FY82-84. At the end of FY84, it will be about \$29.0 billion for FY85-87. On a yearly basis, the cash gap in the first year (FY80) is \$5.8 billion. It is \$6.2 billion for FY81. It is almost \$7.0 billion for FY82, \$7.5 billion for FY83, and \$7.9 billion for FY84. Over the next five years, the cumulative cash gap will be \$34.4 billion. Stated another way, if we borrow \$34.4 billion, our cash position will be exactly what it was at the beginning of the period. That is, at the end of FY84, it would be approximately \$8.9 billion.

The Board, however, has established a policy which provides that the Bank's liquidity will not fall below 40% of the cumulative next-three-year cash gap. We call the amount of borrowing required to maintain liquidity at not less than 40% of the cumulative net resource gap for 3 years our "borrowing requirement".

Accordingly, we have a borrowing program as follows:

\$ 5.3 billion	--	FY80
6.5 billion	--	FY81
7.7 billion	--	FY82
8.3 billion	--	FY83
<u>8.8 billion</u>	--	FY84

\$36.6 billion, or slightly more than \$2 billion over the estimated resource gap for the period.

As you can see from the cash flow table above, that is what is required to prevent the liquidity from dropping below 40% of the next-three-year gap at any time during the period. At the end of the five years, our liquidity will be \$11.6 billion or slightly in excess of what it was a year or two ago. It will constitute 40% of the three-year requirements, not shown on the table for FY85-87.

Essentially, therefore, the borrowing program over three years is merely the mirror image of the shortfall over a three-year period--plus an additional amount needed to hold our liquidity to the designated ratio. The ratio is not sacrosanct;

indeed, by any measure of risk, it provides less protection than 5-10 years ago when the cash gap to be financed on the market was \$1 billion, rather than \$6-7 billion.

THE BORROWING PROGRAM IN PERSPECTIVE

I want to put the borrowing program of \$36 billion in context in terms of its size. In the period 1974-78 we borrowed \$17.5 billion. In the period 1969-73 we borrowed \$6.8 billion. Of the \$36.6 billion, only \$4.1 billion represents refinancing with central banks. The balance of \$32.5 billion represents what we will have to borrow in market operations--an average of over \$6.0 billion a year in the markets. In 3 of the last 5 years, our market borrowings were \$2.4 billion; in one year, \$3 billion and in another, \$3.6 billion.

The table following shows how much we borrowed in specific currencies since 1975, apart from refinancing with central banks.

IBRD BORROWINGS: FY75-FY80 (10/31/79)
(Excluding central bank rollovers)

Fiscal Years	DM		Sw F		¥		\$	Total \$ equiv.
	DM	\$ equiv.	Sw F	\$ equiv.	¥	\$ equiv.	\$	
-----in millions of currency units-----								
1975	I	-	-	-	-	-	1,575	1,575.0
	II	550	234.9	300	120.6	-	500	855.5
	Sub-total	550	234.9	300	120.6	-	2,075	2,430.5
	%		9.6		5.0		85.4	100.0
1976	I	400	153.9	500	189.3	-	1,325	1,668.2
	II	1,250	484.6	650	252.3	-	-	736.9
	Sub-total	1,650	638.5	1,150	441.6	-	1,325	2,405.1
	%		26.5		18.4		55.1	100.0
1977	I	1,350	540.8	550	221.6	-	1,460	2,222.4
	II	1,200	504.9	775	310.4	-	640	1,455.3
	Sub-total	2,550	1,045.7	1,325	532.0	-	2,100	3,677.7
	%		28.4		14.5		57.1	100.0
1978	I	1,150	501.6	525	220.3	100,000	392.1	1,864.0
	II	500	233.4	300	149.3	-	-	382.7
	Sub-total	1,650	735.0	825	369.6	100,000	392.1	2,246.7
	%		32.7		16.4		17.5	33.4
							750	100.0
1979	I	1,300	648.2	2,400	1,430.7	175,000	876.7	2,955.6
	II	-	-	100	58.1	-	-	58.1
	Sub-total	1,300	648.2	2,500	1,488.8	175,000	876.7	3,013.7
	%		21.5		49.4		29.1	100.0
1980		2,450	1,333.0	1,050	630.1	200,000	886.6	2,849.7
	%		46.8		22.1		31.1	100.0
	TOTAL	10,150	4,635.3	7,150	3,582.7	475,000	2,155.4	16,623.4
	%		27.8		21.6		13.0	37.6
							750	100.0

Clearly, the financing for the next 5 years requires penetration of all markets. It can and will be done. Indeed, it must be done to support the Bank's lending program. There are no short cuts. Changes in net income by a few hundred million dollars will have minimal effect on our requirements. Even changes in loan amortization by shifting grace periods one way or another will have minimal effect. Obviously, drastic changes in the Bank's lending program as to amount or sector would in later years have an impact, but not initially, as much as the requirements before you reflect past commitments. Increasing program loans would accelerate the amount to be financed. The key as to our borrowing program, therefore, is when we borrow--not whether we borrow. There is, as yet, no other way to finance the program. There is another point relevant to the size of the borrowing program. A reduction or levelling off in our lending would simply require an absence from market at any point for a few months in order to quickly reduce liquidity. The liquidity at \$11.6 billion by 1984 is modest. It can be drawn down quite quickly. By FY85 the yearly net resource outflow will be \$9.4 billion. Loan disbursements per year will be almost \$9 billion. Outstanding debt will be \$47 billion. Undisbursed loans will be \$38 billion.

LIQUIDITY. TIMING. WAITING

Our liquidity gives us some flexibility to choose--perhaps within a 3-6 month period--when to borrow based on rate or currency considerations. In the future, we will not be able to wait much longer because of the size of our cash outflow. For example, if we must borrow \$7 billion in a given year, we could not wait a year (our liquidity would drop by \$7 billion) and then enter the markets, double up and borrow \$14 billion.

First, the market would not support the Bank in the face of a drop of liquidity from \$10 to \$3 billion and secondly, we can't borrow \$14 billion under even the best

of circumstances in medium- or long-term capital markets. Five years ago when the cash gap was \$1 billion or so, we had more flexibility and could take more risks on market timing, but even then we had to be a rather consistent borrower. More so now and in the future. Liquidity in the past gave us time flexibility. In the future it will provide not much more than working capital.

A decision to forgo borrowing is a function of our perception of whether the market will provide resources later in the amounts needed and, to some extent, the probable real cost. There are many reasons why there is a tendency to borrow now rather than later. We simply would prefer not to use up that 3-6 months leeway on interest rate considerations. We would prefer to use it only when we have to. This view is a fundamental one and relates to our uncertainty of investors' attitudes in a particular market as much as to the reliability of our rate/currency forecasts. What are the uncertainties? 1) Inflation and cost of long-term funds. We don't want LDC's to pay 12%. Our job is not to leave ourselves so little flexibility that we must finance, at the margin, in high cost, inflationary markets; 2) Investors' attitudes toward development; 3) Investors' attitudes toward the Bank versus domestic priorities; 4) Balance of payments constraints in the markets in which we borrow; 5) Attitude of member governments toward the role and function of the Bank; 6) Decline in savings rates; 7) Speculative demand for currencies by non-resident investors; 8) Extent of competition from other issuers who seek to finance their requirements; 9) Attitude of investors toward debt rescheduling or default.

All of these matters involve risks and uncertainty and must be faced up to. Since their positive resolution is uncertain three to five years from now, there has been a tendency to borrow now rather than later. I suggest that tendency will become more evident in the future as the amounts become larger and the "risk" elements more difficult to predict a favorable resolution.

It is not a question of availability of funds. The resources are there, if we diversify by currencies, maturities, sources and timing--i.e., give markets a rest, shift into borrowings from governments and away from the private sector; sometimes tap domestic, sometimes international markets; sometimes go into public markets, other times seek private placements or bank loans. Use new intermediaries. The tables on the two pages following show our outstanding debt by currency and sources of funds. We must continue that diversification. The point is to maintain flexibility so that if matters tighten up in one currency or place we can shift to other sources. That requires a broad base of many types of issues. You cannot enter new markets, for the first time, when the market environment is a bad one.

If all markets tighten for a variety of reasons, then we would have to simply pay more. Then, if access were further restricted, we would have to reduce liquidity. Obviously, if that condition were to continue, depending on the reasons, there would be time to level off the lending program. The effect of such a leveling off on our borrowing requirements of course would not be felt for a few years. Our responsibility is to develop enough flexibility so that never has to happen. Clearly, the greater the liquidity, the longer the period we would have to delay that unhappy situation. I do not want to overestimate, however, the extent of "time flexibility" provided by our liquidity. It costs the Bank little (I do not believe it has cost the Bank anything in recent years) and does provide a useful buffer for a while. It will provide less of one in the future. Nonetheless, it would be pointless and a great tragedy for developing countries to reduce the lending program in the face of our success in financing it. There will be time - and lead time - to take that unfortunate step, should it be necessary. It should be clear to all of us that the most important factor to assure the growth and continuation

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

OUTSTANDING BORROWINGS

By Country of Borrowing

September 30, 1979

(Amounts Expressed in Millions of U.S. Dollar Equivalents
Based on Book Rates of Exchange)

Country	Public Borrowings		Private Borrowings		Total Outstanding	
	No.	Amount	No.	Amount	No.	Amount
United States	30	\$ 6,024.3	2	\$ 25.0	32	\$ 6,049.3
Abu Dhabi	-	-	1	78.9	1	78.9
Austria	-	-	1	31.6 <u>1/</u>	1	31.6
Belgium	2	49.8	1	39.0	3	88.8
Canada	5	81.7	1	12.1	6	93.8
France	1	29.8	-	-	1	29.8
Germany	25	3,535.3	38	3,972.5	63	7,507.8
Iran	-	-	2	350.0 <u>1/</u>	2	350.0
Italy	1	26.5	1	23.1	2	49.6
Japan	10	1,151.2	15	2,578.5	25	3,729.7
Kuwait	6	304.1	1	229.6 <u>4/</u>	7	533.7
Lebanon	-	-	-	-	-	-
Libyan Arab Republic	-	-	4	389.8 <u>3/</u>	4	389.8
Mexico	-	-	-	-	-	-
Netherlands	5	111.1	5	284.6	10	395.7
Nigeria	-	-	1	240.0 <u>1/</u>	1	240.0
Oman	-	-	1	30.0 <u>1/</u>	1	30.0
Saudi Arabia	-	-	- <u>2/</u>	75.0 <u>1/</u>		
	-	-	4	855.0 <u>1/</u>		
	-	-	5	529.2 <u>5/</u>	9	1,459.2
Sweden	2	32.7	-	-	2	32.7
Switzerland	18	1,343.8	27	3,271.0	45	4,614.8
Trinidad & Tobago	-	-	1	5.0 <u>1/</u>	1	5.0
United Kingdom	1	9.9	1	64.5 <u>6/</u>	2	74.4
Venezuela	1	17.5	1	93.1	-	
	-	-	1	372.0 <u>1/</u>	3	482.6
Yugoslavia	-	-	2	130.0 <u>1/</u>	2	130.0
Central Banks	-	-	4	1,350.0 <u>1/</u>	4	1,350.0
Interest Subsidy	-	-	1	193.1 <u>1/</u>	1	193.1
Totals:	107	\$12,717.7	121	\$15,222.6	228	\$27,940.3

1/ In U.S.\$.2/ Portion privately placed of two issues counted under "United States - Public Borrowings".3/ Includes Swiss Francs 100 = \$64.5; Netherlands Guilders 100 = \$51.8; Deutsche Mark 300 = \$172.24/ In Deutsche Mark.5/ Includes Swiss Francs 500 = \$322.3; Deutsche Mark 100 = \$57.4.6/ In Swiss FrancsTreasurer's Department
Financial Operations Division
December 3, 1979

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

OUTSTANDING BORROWINGS

By Currency of Borrowing

September 30, 1979

(Amounts Expressed in Millions of U.S. Dollar Equivalents
Based on Book Rates of Exchange)

<u>Country</u>	<u>Public Borrowings</u>		<u>Private Borrowings</u>		<u>Total Outstanding</u>	
	<u>No.</u>	<u>Amount</u>	<u>No.</u>	<u>Amount</u>	<u>No.</u>	<u>Amount</u>
United States dollars	30	\$ 6,024.3	20	\$ 3,656.7	50	\$ 9,681.0
Belgian francs	2	49.8	1	39.0	3	88.8
Canadian dollars	5	81.7	1	12.1	6	93.8
Deutsche mark	25	3,535.3	41	4,431.7	66	7,967.0
French francs	1	29.8	-	-	1	29.8
Italian lire	1	26.5	1	23.1	2	49.6
Japanese yen	10	1,151.2	15	2,578.5	25	3,729.7
Kuwaiti dinars	6	304.1	-	-	6	304.1
Lebanese pounds	-	-	-	-	-	-
Libyan dinars	-	-	1	101.3	1	101.3
Netherlands guilders	5	111.1	6	336.4	11	447.5
Pounds sterling	1	9.9	-	-	1	9.9
Saudi Arabian riyals	-	-	1	149.5	1	149.5
Swedish kronor	2	32.7	-	-	2	32.7
Swiss francs	18	1,343.8	32	3,722.3	50	5,066.1
United Arab Emirates dirhams	-	-	1	78.9	1	78.9
Venezuelan bolivares	1	17.5	1	93.1	2	110.6
Totals:	107	\$12,717.7	121	\$15,222.6	228	\$27,940.3

Treasurer's Department
Financial Operations Division
December 3, 1979

of our lending program, is simply the image of the Bank, about which I will say more later.

The borrowing program as it develops over a year is now partially a reflection of our views on interest rates and currency risks and to some extent a concern about "doubling" up in the future. That concern will become greater in future years. After all, no government has given us guaranteed access to future markets. No government has guaranteed either a maturity or an interest rate.

In order to develop and maintain flexibility and diversity, sometimes there are trade-offs - risks which affect profitability, i.e. we borrow even though rates might, I repeat might, be lower later. For example, our recent borrowing in Japan is a good example. It is costly compared to the past. We expect interest rate increases in early next year. Later, it is likely rates will decline to current levels and possibly lower, say, by next June. Therefore, the borrowing you considered on Tuesday might be considered somewhat expensive. But in May, June, July of 1980 we will have to borrow in Japan again to finance a \$6.5 billion FY81 program. Are we certain we can double up in June? No. In short, if we don't borrow Yen now, it adds greatly to the probability that we will have to borrow dollars at 10-11% later. We would be forced to enter the US dollar market in a larger amount than we would prefer. We certainly do not expect 8-1/2% long-term dollar rates. Therefore, the decision to borrow now in Yen is a reflection not so much of rates now in Yen compared to June, but rather (1) can we double up; (2) and, if not, what are other alternatives; (3) how costly will they be; and (4) is there, as a practical matter, an assurance that if we delay, there will be other 12.3-year maturities available. We have borrowed four times in the U.K. in 1951, 1954,

1959 and 1971; four times in Belgium in 1959, 1971, 1972 and 1973; once in France in 1972. We have not borrowed in Italy since 1973. Our last borrowing in Holland was in 1976. We have borrowed but twice in Canada in the last 10 years.

In Japan we did not borrow for three years (1975-77); in Germany not for 18 months (1974-75). That's when we borrowed substantially in the US. At other times we did not have access to the US market. In Japan it is likely that non-resident issues will be limited in calendar 1980.

Markets in Swiss francs sometimes are completely closed. We have not borrowed in Sweden in six years. Interest rates in the U.K. are above 15%.

We simply, therefore, do our best to get funds now at what appear to be best rates and overall potential cost to permit financing the institution. Our responsibility is to get the first phone call when a market opens up or improves. Certainly we will ask whether it will improve further and will consider the exchange risk. But what we might benefit in "profitability" or lower real cost must be measured against the amount of funds that will be later available. There has been talk from time to time that, in an inflationary environment, funds are always available - witness the Euromarkets - where LDC's are large borrowers. I would simply note here that these are at variable interest rates and therefore involve a pool of financing not appropriate for the Bank, given the fact that the Bank makes fixed rate loans for 15-20 years.

WHAT ARE PRIMARY CONSIDERATIONS FOR BOND BUYER? First, it should be recognized that there is a difference amongst countries and investors. And a bond buyer places different emphasis on the following elements at different times. Basically, these are the points which "sell" the Bank:

1. Rising income - both trend and level;
2. Liquidity - both trend and level;
3. Importance of Paid-in Capital;
4. Diversity of borrowings; particularly holdings of governments; diversity of sources, maturities, currencies;
5. No defaults, no rescheduling;
6. Callable capital and effect of contingent liability on Bank's financial policies as developed by management and Board;
7. Project Appraisal; Supervision; Creditworthiness studies;
8. Quality and commitment of Bank staff;
9. Non-political nature of Bank;
10. Humanitarian and moral grounds;
11. Practical advantages to developed countries;
12. Role of IDA.

INCOME AND LAGS

Because this seminar is so close to the lending rate paper, I would like to discuss only income, though it is not necessarily the most important element.

Technical reserves don't really interest the bond buyer, i.e. whether they are 10% or 20% of our loans. The bond buyer, rather, wants to make sure our cash flow and liquidity protect him. He is not so concerned about an accounting entry on our books. Since the bond buyer does not have access to our cash flow, let alone his role in that picture, current and future earning capacity is what counts. We focus his attention on four points: (1) the 50 basis points positive spread between the rate on new loans as compared to the rate on new borrowings; (2) the interest rate on disbursed loans versus outstanding debt; (3) the interest

rate on undisbursed loans versus outstanding debt; (4) the interest rate on undisbursed loans versus cost of total funds. The Chart following shows this data and the trends.

We project the following rates for June 30, 1980:

Return on Outstanding Loans	-	7.9% (including commitment fee)
Cost of All Outstanding Debt	-	7.2%
Cost of Marginal Debt (One Year)	-	7.75%
Cost of Total Funds	-	under 6%
Return on Undisbursed Loans	-	7.9%

The prospective bond buyer looks at the recent costs of borrowing and compares those costs to the return on outstanding loans in order to determine if we made mistakes in the past (he knows we are not fully funded). He also looks at our marginal costs - about 7.75%, and our current lending rate - (8.25%). He looks at our future earning capacity on undisbursed loans (7.9%) to see if we have income-generating power for the future. Are we subsidizing our loans at 8.25% - since it is unlikely that we will be able to finance loans now made at 8.25% at 7.75% or even at 8.25%. There is no easy answer. That is why we focus his attention on the cost of total funds, which includes our equity base of almost \$7.0 billion. That reduces our costs of total funds from 7.2% (borrowed funds) to less than 6% (debt plus equity).

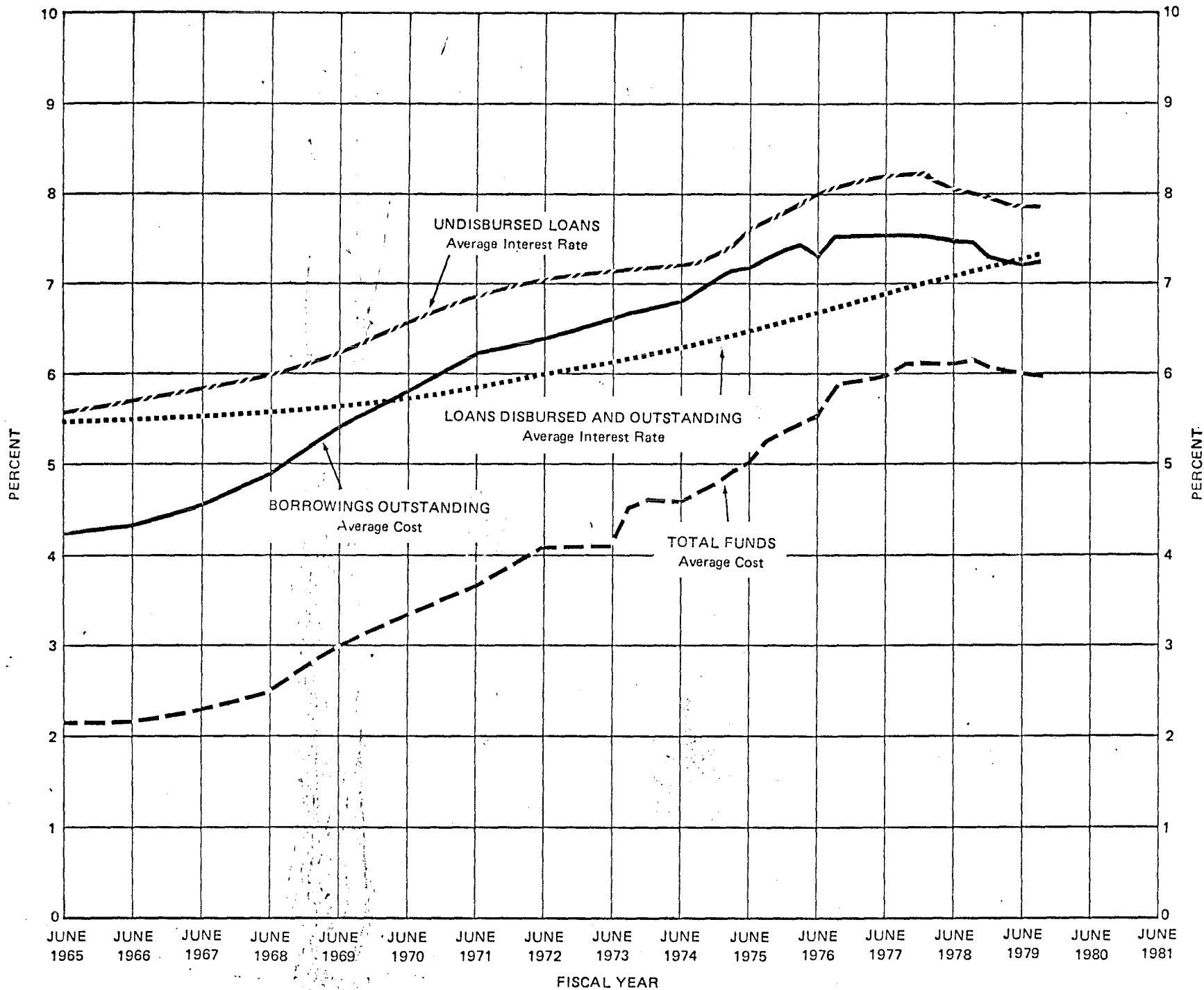
The prospective bond buyer also examines the cost of borrowing in recent years simply to see if we borrowed wisely in the past or whether we have mortgaged our future earning capacity. The costs are set forth below:

FY77	7.85%	(\$4.7 billion)
FY78	6.90%	(\$4.0 billion)
FY79	6.54%	(\$5.1 billion)
FY80	7.65%	(\$3.7 billion to date)

Those costs support an 8.25% lending rate. In short, we show the bond

I.B.R.D.: AVERAGE RATES ON LOANS, BORROWING AND TOTAL FUNDS

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buyer the long-term effect of our income and expense items. The fact that income rose to somewhat rather high levels because of the positive return on liquidity is a plus--an added kicker. It is nice to have but he knows it is temporary and not a reflection of fundamental financial strength or wisdom. It simply offers us some flexibility without placing a burden on LDC's.

One word about reserve accumulation. I would suggest that one or two debt reschedulings will have manyfold the effect as compared to the equivalent amount, in present value terms, of an IDA transfer or allocation for research, or a dividend, all of which might equally reduce reserve accumulation. In short, the bond buyer is not so much concerned about the level of reserves, as whether we have "earning capacity." He does not look at the potential erosion of capital. After all, it's yours, not his. Rather, he is concerned whether our cash flow is interrupted, how quickly our liquidity would decline and whether our earning capacity is impaired. Bond buyers who are trained to look at interest coverage (net income as a percentage of our total interest payments) would not be comfortable seeing that ratio decline from 3:1 to, say, 1.05:1 in the face of debt reschedulings. They also would not take kindly to penalizing the bond buyer (by rescheduling) for our mistakes. Particularly if he is a prospective or new bond buyer. The fact that our "reserves" are 8% or 20% of our outstanding loans - is an irrelevancy - at best - under such circumstances. In short, the bond buyer looks at the current and future environment, not so much the technical financial resources - our "reserves," which they know are at risk on outstanding loans. A policy to reschedule or defaults would make that risk apparent.

I would like to conclude my remarks on income with some general comments about the lag effect of a change in the Bank's lending rate. They are linked in one sense. We borrow and adjust the lending rate on new commitments to reflect a positive spread over the cost of borrowing. However, there is no link

to current income. This is unlike a commercial bank where marginal borrowing costs are passed on to new borrowers and old borrowers with an immediate effect on income. Prime rate changes affect the rate on outstanding loans. At the Bank, our lending rate, once set, remains fixed. A change in the lending rate affects only new loans and, given the lag on disbursements, the effect of a change in the lending rate will not affect income for several years. But increased costs of borrowings will have substantial effect on current expenses. Two billion dollars borrowed at 11% compared to 8% (say in DM) will affect our income by \$60 million in this year alone. That's the immediate effect of a US issue. No change in the lending rate can change the effect this year. Indeed, we would change the lending rate from 7.95% to 15% for the next six months, and it would not have a discernible effect this year and minimal effect next year. Indeed, income likely would rise even without any change in the lending rate for two years, as the short-term cash return will mask the effect of higher costs on current borrowings. For example, if we borrow at 11% now, income will rise next two years because we can buy dollar two-year bonds at 12%. Therefore, we must look through short-term rising income and make sure the lending rate, over time, correctly reflects the borrowing costs.

Since the costs must be passed on, we are particularly anxious to tap DM, Yen and Swiss francs in the longer maturities when available at 7-1/2 to 8-1/2% level without, frankly, being absolutely certain that they won't be 1/2% lower in six months. And even if it involves an "advance" borrowing. Because if we were wrong on a projected decline in rates, or if those markets disappear, as happens, we will find ourselves borrowing mainly dollars at 11% and lending at 11-1/2%. We want to avoid that situation simply because we believe that the cost of non-dollar borrowings is less, in real terms, than the currency risk given the

interest rate differential. The decision to borrow DM, and disburse it (a typical condition of the borrowing) may turn out to be a mistake or a wise one for the Bank and its borrowers depending on whether and how much the DM revalues against the US dollar over the life of the loan and how the Bank allocates or passes on that risk to the borrowers. But the decision is a "rational" one in the sense that it is not taken at random or without regard to the risks. But we cannot assure that we won't make mistakes. Indeed, a dollar borrowing at 11% may also be a mistake - it is not without risk (given the certain and required increase in the lending rate for the next 16 years) if the DM does not substantially revalue.

MATURITY OF BORROWINGS

The maturity of our debt is important. In the last two years our borrowings had an average life of over nine years. The average life is about 6.30 years for the \$28 billion of outstanding debt. This is somewhat misleading because that figure includes our Two Year Central Bank issues, The Bank of Japan borrowing (6-1/2 years) and the Bundesbank holdings (5 years). We do not believe there is a cash flow risk or maturity risk on these borrowings, but since our loans are at a fixed rate for a longer term, there is an interest rate risk. The maturity of our market operations is about 8.5 years. Also, though our new loans may have a maturity of 13 years, the average life of outstanding loans is only 9 years. The interest rate risk - represented by a difference between 6-1/2 year debt profile and a 9-year loan life conceptually may be said to be financed by the equity base of the Bank which provides 25% of the Bank's resources. I might also note here that we tend to borrow medium-term, say, five years, only if there is a high probability of refinancing, i.e. bank loans rather than public issues.

As I noted earlier, we do not borrow short, i.e., with variable interest rates, though these funds are in plentiful supply, e.g. Eurocurrency credits, CD's, commercial paper, discount notes. Unless the Bank passes on the volatile and variable nature of the interest rate risk through a variable lending rate, those funds are unavailable to us as a practical matter.

We don't borrow SDR's because no one wants them as an investment. It is too complicated for the unsophisticated and for those who wish to make financial decisions to maximize profit (a not unexpected standard for financial institutions), it provides little attraction. For those who wish to offset specific risks, it provides even less interest. Basically, what makes it attractive for borrowers - a diversified basket - is what makes it unattractive, as a practical matter, for those who are compensated for making, not avoiding, financial decisions. I believe that is why there is no decent primary or secondary market for SDR-denominated obligations.

The Eurodollar bond market is merely the label for dollar-denominated obligations sold outside the US through a non-US syndicate. We tap those same investors through US issues. There are also some technical aspects of the market which could seriously interfere with our US market issues.

To conclude: Basically, we expect to borrow in the next five years about 50% of our borrowing program in US dollars, 40% in Deutsche mark, Yen and Swiss francs and 10% in other currencies - plus our central bank refinancing with The Bank of Japan, the Bundesbank, our two-year issues and refinancing of maturing holdings with OPEC. We would expect that of our new funds about 20% could be placed each year with governments, including OPEC. If we can borrow a greater percentage of DM and Yen, at 8 - 8-1/2% and 5-1/2% in Swiss francs,

we will do so. We will seek to open up new areas, attempt to avoid high cost markets (in real terms) and seek to avoid saturating any one market.

One final point. The Bank is complicated. It takes time to explain. Each item of resistance can be answered and explained. We see not a little lethargy, ignorance, bias. We will be able to do the job if our image is maintained. The Bank, as it is perceived outside, determines whether LDC's will obtain the resources they need. Our financial image, the things we talk about, are complex and not easy to efficiently communicate to busy, and not particularly involved, pension-fund managers. They read about what we say about ourselves and what others say and, if they are comfortable with the institution and its role in their environment, they will buy our bonds.