

# **Altruists or Bankers? A Comparative Study of How Multilateral Development Banks React to Changing External Circumstances**

Conference Paper  
Emerging Research in Political Economy & Public Policy  
11 March 2009

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**Abstract:** This paper examines how the character of multilateral development banks (MDBs) as financial organizations impacts their mission of promoting development and providing international public goods. It does so through a comparative analysis of three different “types” of MDBs operating in Latin America—the World Bank, the Inter-American Development Bank, and the Corporación Andina de Fomento. The initial research phase discussed here compares financial performance and lending patterns using descriptive statistics accumulated from an extensive review of the annual balance sheets of each of these MDBs from 1975 to 2007. The evidence suggests that each MDB has systematically different reactions to changing external conditions, pointing to inherent competitive strengths and weaknesses derived from differing composition of shareholding countries.

**Key words:** World Bank, Inter-American Development Bank, Corporación Andina de Fomento, emerging market, multilateral aid, Latin America

*Note: This paper may be quoted freely, with full citation*

## **Introduction**

This research project explores what factors drive multilateral development banks to act in the ways they do toward recipient countries. Specifically, it examines how the character of multilateral development banks as financial organizations—a trait often overlooked in academic research on the topic—impacts their mission of promoting development and providing international public goods.

Before moving on, the exact nature of multilateral development banks (MDBs) should be defined. MDBs are international organizations that:

- are created by international treaty among sovereign nations, which act as their shareholders
- have the mission of promoting economic development in less developed countries
- to this end, make loans (as opposed to grants) to sovereign governments, at terms more favourable than available through private markets
- cover administrative costs largely with the proceeds of loans
- raise money to lend largely on private capital markets, with the guarantee of their shareholding countries

The research is motivated by an empirical puzzle. Anecdotal evidence from the activities of different MDBs in Latin America in the mid-2000s indicated that these banks were acting in a variety of ways not necessarily expected, considering their mandates. This included vigorous competition among MDBs to make loans to middle-income countries (through easing loan conditionality and other enticements), pressuring countries to take loans even in the absence of pressing fiscal needs, and developing new business lines outside of traditional development lending.

Also striking was the fact that the largest and most prominent MDB, the World Bank, seemed to be having the most difficulty making loans, while the regional Inter-American Development Bank (IADB) and sub-regional Corporación Andina de Fomento (CAF), appeared to be much more popular sources of multilateral lending. This was true in spite of the World Bank's lower cost of lending and vastly larger non-lending services. The talk among Latin American development specialists was that the IADB and CAF were seeking to "put the World Bank out of business" in the region.

## **Theoretical Framework**

What explains this type of behaviour among supposedly cooperative organizations working toward the same goals? Just professional rivalry, or something deeper? Existing social science theory does not offer any obvious answers, although it does provide some clues. The most useful branches of theory to address the puzzle described above seem to me those that focus on the nature of the organizations in question—how they are

designed and how they function in reality to undertake their tasks. Two strands of theory are particularly well-suited for the task at hand.

*First*, literature arising out of organizational sociology, addressing how organizations cope with resource constraints, can help analyze how MDBs may react to evolving financial pressures. In my view the existing literature on MDBs fail to sufficiently take into account their design as financially self-sustaining organizations, able to generate a certain level of income each year and not needing steady capital replenishments from shareholding countries. This defining trait—non-existent in bilateral or private aid organizations—has made MDBs so demonstrably successful since the World Bank was created in 1944.<sup>1</sup> They provide a number of services of interest to shareholding countries, at very low cost.

Thus each MDB has two important streams of external resources that must be maintained for organizational survival and not be forced to rely on political difficult handouts from shareholder countries: a portfolio of income-generating loans, and appetite for its bonds on private capital markets. Several authors in organizational sociology—notably Pfeffer and Salancik (1975) and more recently Barnett and Coleman (2005)—emphasize how the drive to ensure necessary external resources can strongly shape the strategies and activities taken by an organization as well as individuals within it, even if these strategies and activities are not always in line with the organization’s mission.

*Second*, institutionalist-oriented political economy scholars have in recent years employed principal-agent models to understand the inner workings of international organizations. Broadly put, principal-agent models seek to explain why agents (in this case MDBs) do not always faithfully enact the mandates of principals (country shareholders). Lyne, Nielson and Tierney (2007) point to the “complexity” of principals as a key factor sometimes glossed over in principal-agent literature on international organizations—which frequently assumes that the only principal of interest is simply the US or, at most, the G8. The authors instead take seriously the formal composition and rules of MDBs in attempting to explain shift in social policy lending through the collective preferences of all shareholding countries.

This focus on the complexity of principals and formal decision-making procedures strikes me as a positive step to understanding the real-world pressures impacting MDBs. However, I propose that the composition of MDB collective principals divided between donor, non-borrowing countries and borrowing countries decisively shapes how otherwise similar organizations operate. While all countries have their own particular interests and agendas, the dichotomy between borrowing and non-borrowing countries seems particularly important in the context of an MDB, defining two important groups of shareholders that will tend to

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<sup>1</sup> According to one count (IDS 2000), 24 multilateral development banks were in operation in 2000.

have opposing interests. The relative power of those two groups, I suggest, is a critical feature shaping MDBs—not only within the framework of shareholding principals and staff agents, but also in defining the competitive advantages of different MDBs from the point of view of borrowing countries.

Viewing MDBs through the lens of shareholder composition, I see three “sub-species”:

1. *Donor dominant*: Numerous shareholders, include many wealthy, non-borrowing donor countries with effective veto power of policies (the World Bank).
2. *Borrower predominant*: Many borrowing shareholders and some non-borrowing donor shareholders, who do not have veto power (for example, some regional MDBs such as the IADB).
3. *Borrower dominant*: Shareholding and borrowing countries are one and the same (for example, some sub-regional MDBs, such as the CAF).

Thus, my contention is that by combining a close examination of the financial pressures faced by MDBs with an analysis of the “type” of MDB in question based on shareholder composition, I can explain why MDBs react in certain ways to an evolving “market” for development lending.

### **Research Strategy**

Taking into account the three types of MDBs described previously, and combining that with the importance to MDBs of generating sufficient income to remain self-financing organizations, I posit the following three broad hypotheses:

1. *Shareholder composition shapes the operational characteristics of each MDB*
2. *These operational characteristics shape the competitive advantages and disadvantages of each MDB as a financial concern*
3. *The operational characteristics and institutional design of each MDB will shape whether, under what conditions and how each MDB competes for borrowing clients*

The intention is to seek evidence for or against these hypotheses taking as cases three different banks, one each of the type described above—the World Bank (donor dominant), the Inter-American Development Bank (borrower predominant), and the Corporación Andina de Fomento (borrower dominant). The financial results and operations of these three organizations will be analyzed over time at the level of the entire institution, as well as in two case study countries.

The first phase of the research is to analyze quantitative data gathered from a review of the annual reports of all three organizations from 1975 to 2007, as well as some macroeconomic data on relevant countries. Preliminary findings from this research are discussed in more detail below.

The remainder and larger part of the research will be accomplished mainly with qualitative research derived from text analysis (annual reports, strategy and loan documents, external evaluations by capital market participants and shareholding countries) and numerous interviews (MDB operational and treasury staff, shareholding country officials, borrowing country officials, and capital market participants supplying credit to MDBs). As well, I will undertake a comparative case study of two countries in which all three MDBs operates—Peru and Bolivia—to show how the banks react in markets different in a couple of critical aspects, over the same time period.

### **Hypothesis 2 in More Detail**

The second hypothesis of this research posits that because of their varying organizational characteristics, each MDB has certain competitive strengths and weaknesses that impact its outcomes as a financial concern. This broad assertion has three associated “sub-hypotheses”:

- a) In the long run, borrower-dominant MDBs will show the best financial results, borrower-predominant MDBs the next best, and donor-dominant the worst.
- b) During times of low demand for MDB loans, these trends will be even more pronounced.
- c) During times of crisis, donor-dominant MDBs will see sharply improved performance, borrower-predominant MDBs will also see rising performance though to a lesser degree, and borrower-dominant MDBs will see declining performance.

On the face of it, the first two of these sub-hypotheses may appear surprising. After all, the donor-dominant World Bank has by far the largest amount of resources at its disposal and best access to private capital markets, can offer the best financial terms for its loans, and can bring to bear a vast array of technical expertise, global experience, and policy research capacity. By contrast, the borrower-dominant CAF is only just above investment grade and can hence offer only slightly better-than-market loan terms, faces less reliable access to private capital markets, and has essentially no technical assistance, project implementation or non-lending services to offer borrowing government. Why would the CAF outperform the World Bank in the long run, and especially so during “good times” among borrowing countries?

The answer, I suggest, lies in the organizational characteristics derived from shareholder composition. The full exposition of this will come during the research into the first hypothesis, but the broad outline is as follows.

Because the CAF is entirely dominated by borrowing countries, it has the disadvantages noted above. But, also because it is borrower dominant, the CAF has:

- no incentive to require onerous conditions to the loans, in the form of policy conditionality or stringent fiduciary and procurement oversight
- much faster loan processing speed and less time commitment required by government officials, due to a small, vertical management structure and few competing internal constituencies
- no political cost for use by borrowing governments, as they control the organization

By contrast, the donor-dominant World Bank has:

- numerous demands from powerful non-borrowing shareholders to attach various types of strings to loans
- a huge staff, multiple layers of bureaucracy and competing internal constituencies that make loan approvals a slow, difficult process requiring significant time commitment by government officials
- non-negligible political cost attached to using its services due to the perception that it is a tool of powerful countries

The borrower-predominant IADB enjoys some of the same advantages as the World Bank in terms of access to resources, and finds itself in a somewhat intermediary position with regard to other characteristics, such as:

- some push for loan conditionality and oversight, which can be resisted in most (but not all) circumstances with concerted effort by borrowing country shareholders
- a relatively large and slow bureaucracy, although with few competing internal constituencies and a more “neighbourly” cultural affinity with borrowing governments
- some political cost to use, as the IADB is located in Washington and is viewed as having strong donor (US) influence, despite its strenuous efforts by operations staff to be seen as a friend to borrowers.

The contention is that in most economic conditions faced by borrowing governments, and especially when borrowing governments either have low demand for MDB loans and/or good access to alternative sources of sovereign capital, the characteristics noted above are pre-eminent. In these circumstances, the marginal cost differences between sources of sovereign capital become less important. Hence, the CAF will perform the best, the IADB next best, and the World Bank worst.

During times of financial difficulty for borrowing governments, however, the situation reverses, and the donor-dominant World Bank becomes the “go-to” lender. This is mainly because of the unequalled amounts of financial resources it can bring to the table, whatever the economic circumstances. The World Bank’s reserves, AAA rating and vast network of bond purchasers make it not far behind US Treasury bills as a safe investment, giving it a reliable and large pool of capital to work with.

Also, to governments facing major difficulties, the marginal cost advantage of World Bank loans becomes significantly more important. And lastly, coming on board with a World Bank program can act as an important signal to private financial markets that a government is being a “good student”, possibly promoting capital inflows (or at least reducing outflows).

The borrower-predominant IADB also finds itself in an improved lending position during times of crisis. Because it has major wealthy governments as shareholders, it also has a AAA rating and hence strong capital market access, although not as strong as the World Bank. Hence it can also bring sizeable amounts of capital to bear in the face of a crisis, also at attractive interest rates. The signalling effect to international markets of an IADB lending program is negligible, however.

The borrower-dominant CAF is expected to face significant difficulties in times of crisis. Its access to capital markets is good, but unreliable if investor sentiment turns against the region, as it is considered by the markets to be not much more than an extension of several countries in South America, with no wealthy country shareholders. Also as a result of its shareholders, CAF loan terms are only slightly below market rates, hence less attractive to governments in difficult straits than the IADB or World Bank.

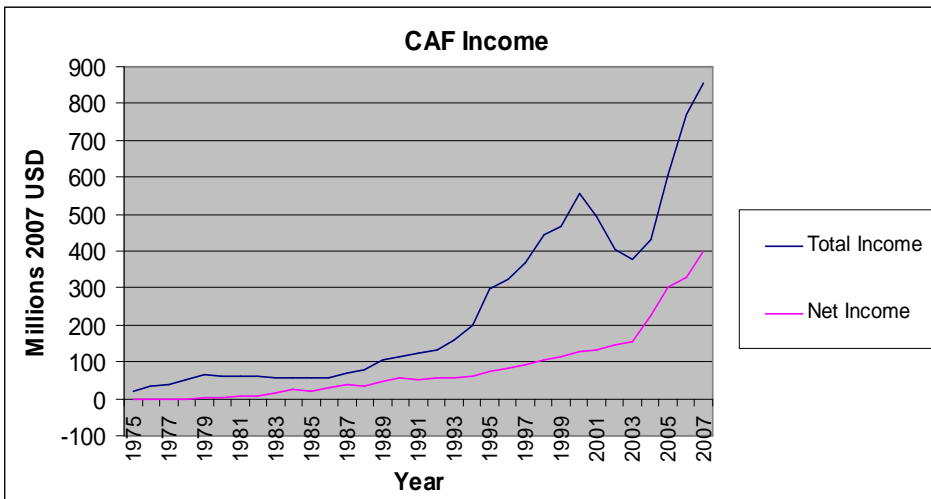
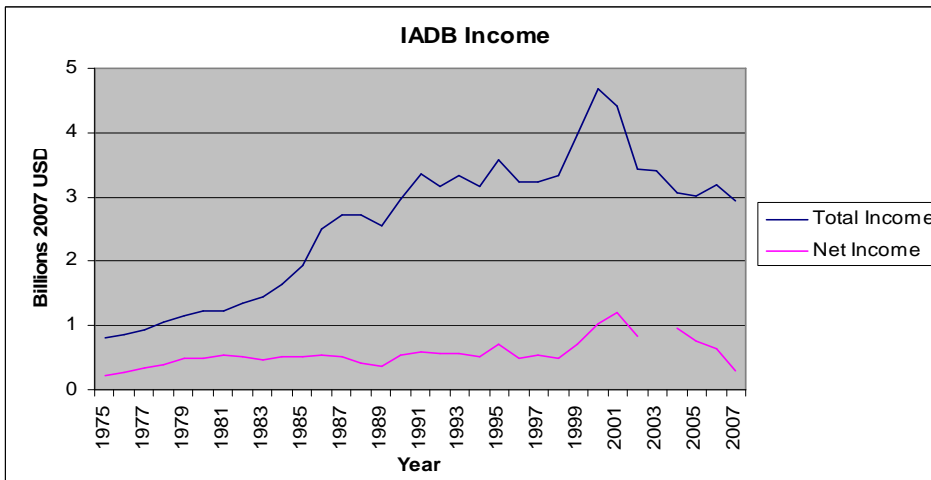
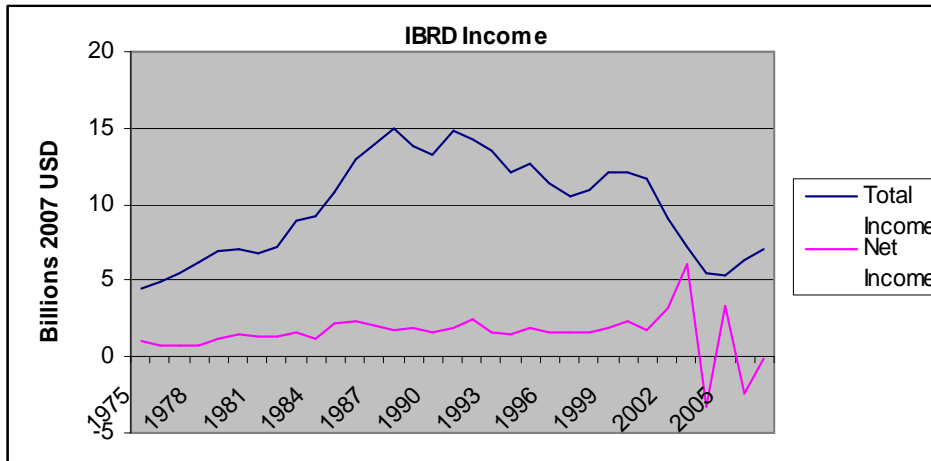
## **Quantitative Evidence for Hypothesis 2**

The following three sections present some initial findings derived from quantitative research into the annual reports of each of the three organizations in question, from 1975 to 2007. The research first looks at financial results for each MDB as a whole, followed by comparing lending by the MDBs to two sub-sets of countries. Most of this evidence from this research appears to support hypothesis 2 and its three sub-hypotheses described above, while other findings are less clear. Lastly, the paper outlines a possible methodology to analyze country-level lending patterns with regression techniques.

It should be stated at the outset that these findings are not intended to prove causality, merely to lend support to the hypotheses. Deeper qualitative investigation must and will be undertaken to establish causal links.

### ***Overall MDB performance***

The most obvious proxies for financial stability of a banking institution would be annual total income (deriving from both lending operations and investments) or annual net income (total income less administrative and debt expenses). The total and net income for all three MDBs is presented below.



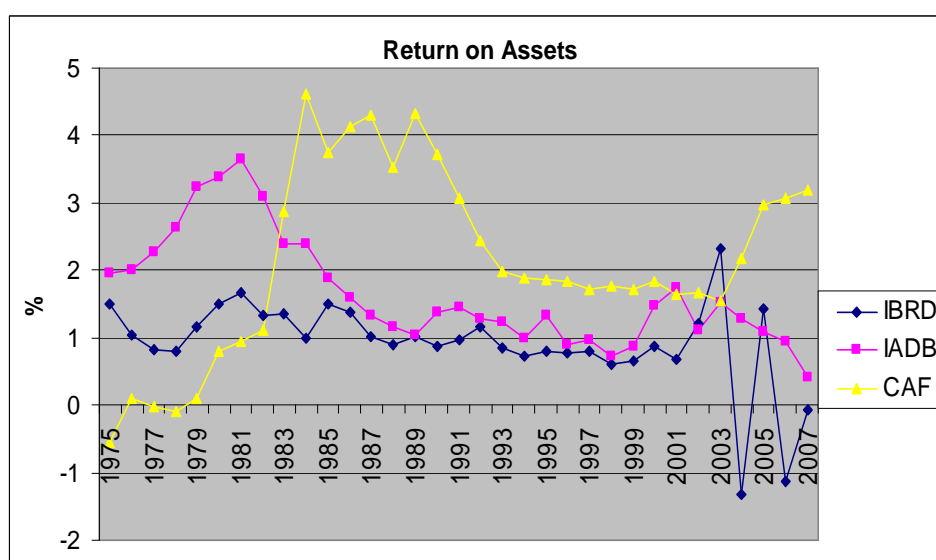
Trends in total income seem to support the hypothesis well. IBRD<sup>2</sup> total income peaks in the late 1980s and then declines steadily, while IADB total income plateaus (with some volatility) after the early 1990s. The CAF, by contrast, shows steady total income growth, apart from a sharp reversal for a few years in the late 1990s-early 2000s.

<sup>2</sup> International Bank for Reconstruction and Development—the main lending branch of the World Bank.



Net income trends of the IADB and CAF both roughly parallel total income, suggesting a relatively close link and also supporting the hypothesis. By contrast, the IBRD shows relatively steady net income from the late 1980s to the early 2000s, followed by extreme volatility in the last few years. This appears to have no relation at all to total income. The recent volatility in IBRD income is related to the investment component of total income, as accounting rules changed in 2003 related to the reporting of income from derivative instruments which has fluctuated wildly in recent years. The overall steadiness of IBRD net income is less easily explained, but likely is related to investment income.<sup>3</sup>

It may be (rightly) noted that comparing the total and net income streams of these three MDBs has only limited value, as they vary greatly from one another in terms of size. To control for this, another pertinent comparison, and one used frequently by the private sector to compare the health of financial institutions competing in the same industry, is return on assets (ROA): net income/total assets. ROA indicates how much a given company earns relative to the amount of assets it controls. Trends in ROA for the three MDBs in question are portrayed below.



As is evident, ROE trends are even more starkly supportive of the hypothesis that borrower-dominated MDBs will exhibit the best financial performance, borrower-predominated MDBs second best, and donor-dominated MDBs the worst.

Two additional features in this graphic are worth addressing. The first is the superior performance of the IADB over the World Bank and CAF in the late 1970s, followed by a sharp decline in the 1980s. This seems to lend support to the sub-hypothesis that when times are “good” for

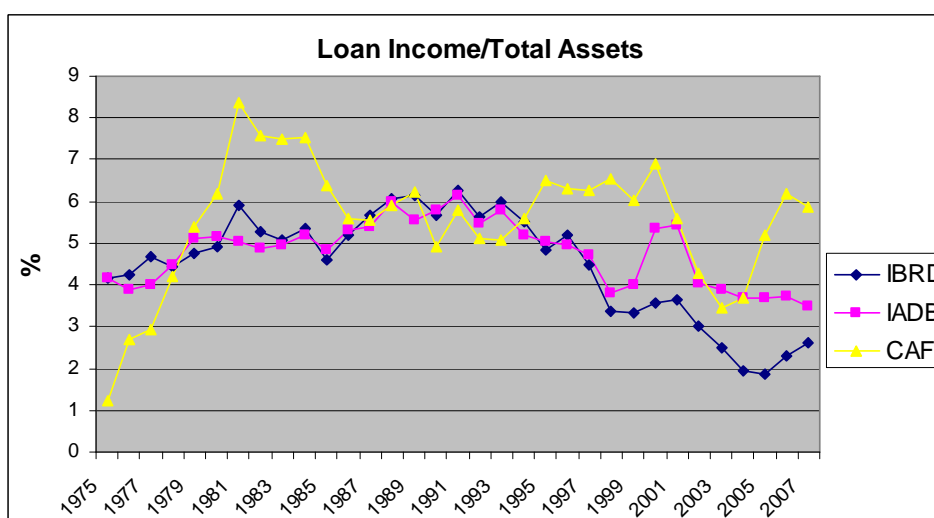
<sup>3</sup> Although investment income trends are interesting and will be explored in more detail during the course of research, they are not the focus of the current research, which is on how financial pressures shape MDB interactions with developing countries. As well, trends in investment income as a share of total income (available on request) are quite similar for all three MDBs.

borrowing countries, a donor-dominated MDB will be the least preferred source of loans. The late 1970s would qualify as a “good” time for borrowers, as this was the time of the petro-dollar lending boom in the developing world, including Latin America. This quickly reverted in the early 1980s, although the income payments from loans made in past years smoothed the negative impact on the IADB’s net income.

The second is the initially poor and then extremely good performance of the CAF. This likely has to do with the fact that the CAF was only founded in 1970, and took a number of years to build up the capital resources and reputation among both capital markets and borrowing governments to become a serious source of lending. By the early 1980s, it had achieved a “critical mass” of support that allowed it to begin lending more heavily, although its asset levels did not change markedly until the late 1980s. This could explain the spike and subsequent decline in ROA. However more research is required to address this puzzle.

The question arises as to what component of ROA maybe behind this differentiation between the financial performances of the three MDBs. Varying ROA outcomes could be caused by investment income, administrative and financial expenses, or the evolution of assets. These all may be related to the underlying hypothesis that an MDB’s shareholding structure generates certain operational characteristics, and will be explored further with descriptive statistics and (especially) qualitative research.

But the most obvious explanation component is loan income trends, considering that loan income generates 80 percent or more of total income for each of these organizations. The graphic below compares loan income relative to total assets—that is, how much loan income an MDB generates according to its size. Here again, the data broadly supports the hypothesis in question, with the CAF generally outperforming the other two MDBs, and the World Bank performing the worst, starting in the early 1990s.

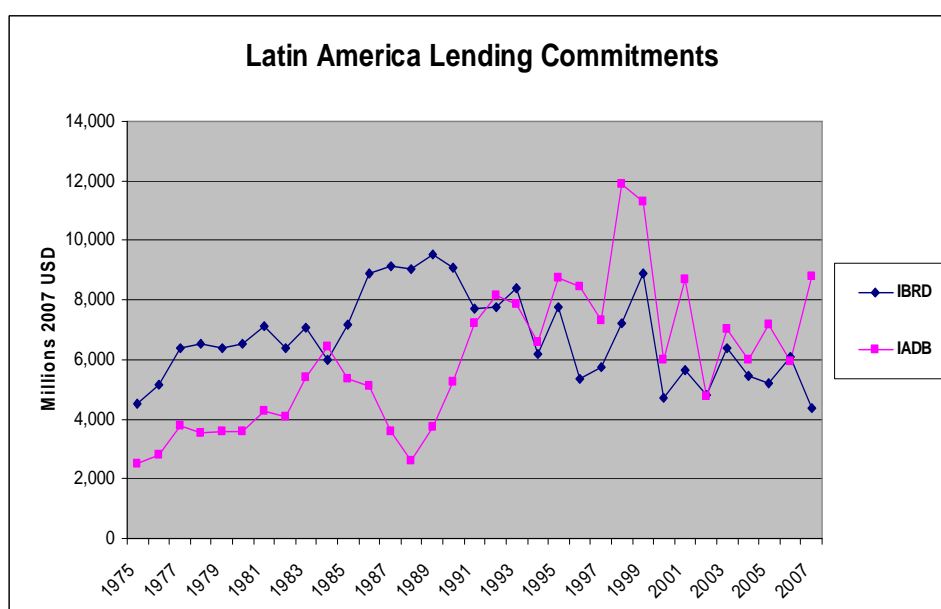


### *Lending trends by groups of countries*

The comparisons in the previous section, though indicative, are imperfect. The World Bank, of course, operates on a global scale, the IADB on a regional scale, and the CAF in only five countries.<sup>4</sup> Hence comparing their aggregate financial outcomes is not entirely apt, since they operate in very different markets. More telling would be the financial outcomes of each of three MDBs in the same group of countries. This, unfortunately, is not possible, as none of the three MDBs break down income and expenses on a country or regional level.

The best approximation for comparing financial outcomes is the amount of lending by each organization in a given country or group of countries. This is less than ideal, as expenses are not taken into account. As well, one must be content with annual loan commitments and outstanding loan portfolio, since piecing together actual loan disbursements year by year and country by country would be exceedingly time-consuming, and in some cases the data is not available at all. Nonetheless, loan commitments and outstanding loan portfolio do offer a reasonably good approximation of how the income of an MDB from a given country or group of countries evolves over time.

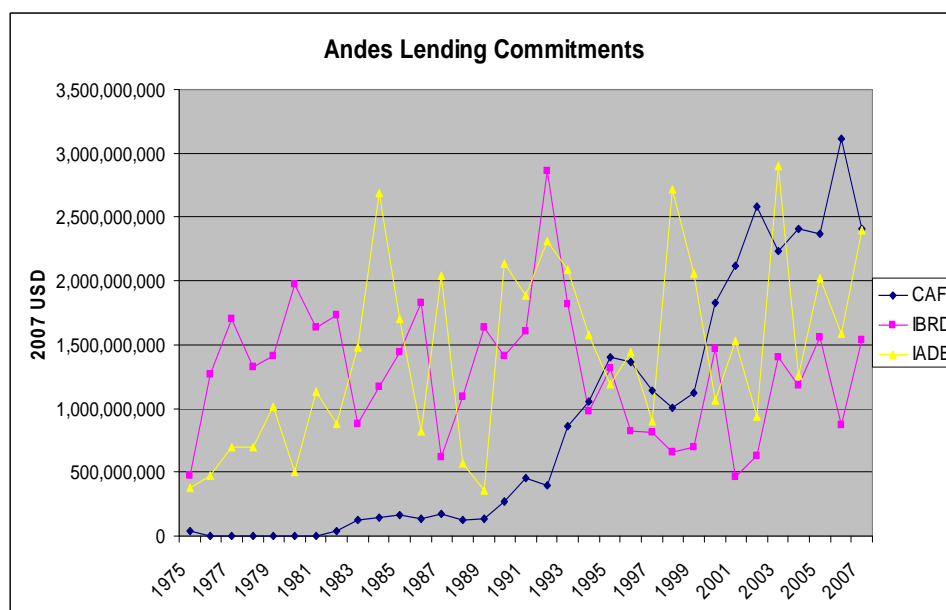
Comparing lending commitments can be done on two levels. The first, looking at all of Latin America, necessarily involves only the World Bank and IADB. The second tracks the lending commitments of all three MDBs in the five countries of the Andean region—Bolivia, Colombia, Ecuador, Peru and Venezuela. The results are presented below.



The patterns of lending commitments between the IADB and World Bank offer relatively clear interpretation. The sharp drop in IADB lending

<sup>4</sup> In recent years the CAF has begun lending operations in other Latin American countries, but this remains on a very small scale compared to its core Andean market.

throughout the 1980s seems to support the sub-hypothesis that the World Bank becomes the preeminent multilateral lender during times of financial crisis. The underperformance of the IADB during the 1970s fits less well into the hypothesis that predicts that it should perform better than the World Bank during “good” times, although the greater volume of IADB lending starting in the mid-1990s bears out that prediction. It may be that some of the factors that I suggest work against the World Bank as a preferred lender were less evident in the 1970s than now, such as political cost, policy conditionality or onerous lending requirements. This will require further qualitative research to verify.



MDB lending trends in the Andes are significantly more volatile than in the region as a whole for the IADB and World Bank. However the pattern of greater lending volume by the World Bank earlier in the period followed by gradual overtaking by the IADB starting in the early 1990s holds true. The performance of the CAF is much more steady, with a clear rising trend from inception to the present day, pointing to significant advantages faced by the CAF as a preferred multilateral lender by Andean governments. The temporary decline in lending during the late 1990s is not obviously explained and merits further investigation, but may be related to the sharp spike in IADB lending in the same time period.

Interestingly, the sharp decline in IADB lending in the 1980s across the entire Latin American region is not clearly evident in the Andes. This could be because the Andean countries were not as strongly impacted by the debt crisis as other major Latin American economies such as Mexico, Brazil and Argentina. However further investigation is needed to provide a more satisfactory answer.

### *Preliminary conclusions from the evidence*

The evidence outlined above on overall MDB financial performance and lending commitments provides backing to the hypothesis in question. It seems that the three MDBs analyzed do indeed face different “market conditions”, as evidenced by the systematic variations in overall financial performance and especially lending patterns. This is particularly true in the Latin American “lost decade” of 1980s, when World Bank lending commitments rose substantially and those of the IADB declined, and beginning the early 1990s when both the CAF and IADB began to supersede the World Bank as the preferred multilateral lender.

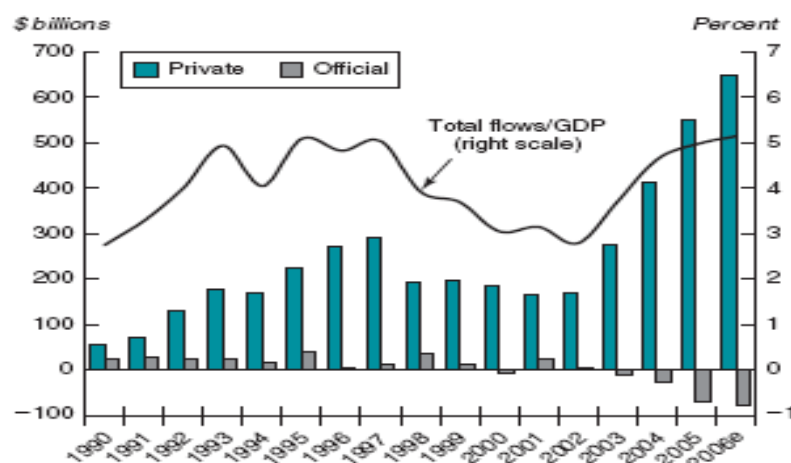
Evidence for the years prior to 1980 is more mixed. As noted above, this may be because the “character traits” that I posit are driving the preference of a government to borrow from one MDB over another, such as policy conditionality, bureaucratic requirements or political cost, may have only come to importance in recent years. This will be an important area of further qualitative research.

The broad trends, though, seem quite clear. After an initial period of minimal importance in the 10 or 15 years following the creation of the CAF—when it had to slowly establish its position as a reliable borrower in capital markets, which in turn impacted the attractiveness of the terms it could offer governments—this MDB has risen steadily in importance as a multilateral lender in the Andean region. It is now clearly the leader in MDBs in terms of total lending in the five Andean countries. And even as early as the 1980s, overall financial performance as proxied by ROA was superior to the other two MDBs.

By contrast, the World Bank has gone from a position of superior overall financial performance and lending dominance over the other two MDBs in the 1970s and 1980s to the bottom position in the 2000s. The IADB has tracked a middle course, gradually taking over market share from the World Bank in the Latin America region and holding its ground in the Andean countries despite the exceptional growth of the CAF.

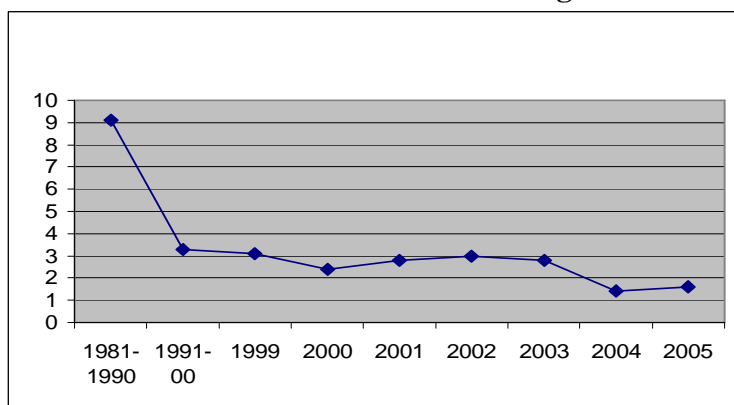
The inflection point of the early 1990s, apparent on all the lending trends as well as total income trends, is particularly noteworthy. This change in the trend lines is likely to arise from a combination of demand and supply factors. On the demand side, Latin American governments exhibited much improved fiscal outcomes starting in the 1990s. As well, the 1990s saw the start of a huge upswing in private capital available to emerging market economies, thus greatly increasing the alternative supply of resources to borrowing governments. Both these trends are indicated in the graphics below.

## Net Capital Flows to Developing Countries, 1990-2006



Source: World Bank Global Development Finance, 2007.

## Latin America Central Government Budget Deficit/GDP



Source: World Bank, Latin America Chief Economist's Office.

In the face of reduced demand for multilateral lending caused by the above trends, the World Bank appears to be the most negatively impacted. When governments have a choice, the World Bank seems to be the first multilateral lender to get dropped, while the CAF faces the greatest demand for services and the IADB falls somewhere in between. The importance of private capital flows may be pre-eminent in causing this, as suggested by the fact that the World Bank's total global income (not just in Latin America) began declining in parallel with rising capital flows.

These trends all speak to some important advantages and disadvantages faced by each of these organizations that are beyond the realm of short-term fluctuation or coincidence. In my view, the most appropriate way to get at the causal factors behind these patterns is through qualitative research, both within the organizations and among borrowing country governments. However, the possibility exists for further quantitative analysis at the country level, which is explored in the next section.

### ***Lending trends by country—how to proceed?***

In light of the revealing patterns found looking at lending trends by MDBs within groups of countries, it seems logical to extend the analysis to the country level. At the end of this paper are examples of MDB lending in six Latin American countries, the first three—Brazil, Mexico and Argentina—involving only the World Bank and IADB, and the second three—Colombia, Peru and Venezuela—also involving the CAF. As is immediately apparent, the situation at the country level is considerably less clear than the aggregate trends described above. Volatility is much higher, and regular patterns are much more difficult to discern, except perhaps in the case of Brazil.

It would seem then that simple descriptive statistics at the country level would not be of as much use in generating support for the hypotheses. The question then arises whether more advanced statistical methods could be usefully brought to bear. Below are the outlines of two possible methods to use country-level data to get at the causal factors behind MDB lending. These approaches are extremely tentative, and are presented here in the interests of receiving feedback on whether they seem feasible or even useful for the overall research project.

One option would be to run a total of five regressions: one each for the IADB and World Bank using data from all major Latin American countries not in the Andean region, and one each for the IADB, World Bank and CAF with data from the five Andean countries, between 1975 and 2007.

The dependent variable would be annual lending commitments. Each regression would seek to test the statistical significance of a number of independent variables that could impact annual lending commitments. Then, the results of each regression would be compared (the first two against each other, and then the last three against each other), to ascertain whether what variables impact the “preference” for borrowing from each MDB.

Another option would be to take as the dependent variable the share of total MDB borrowing a government takes each year from a given MDB. One regression would look at borrowing by all major Latin American countries not in the Andean region (for just the IADB and World Bank), and a second regression would look at all countries in the Andean region (for all three MDBs). Each regression would seek to test the statistical significance of a number of independent variables that could impact how much is borrowed from which MDB.

The independent variables currently under consideration include:

- Fiscal deficit
- Alternative sources of sovereign capital (bonds, bank loans, IMF, bilateral loans/grants)

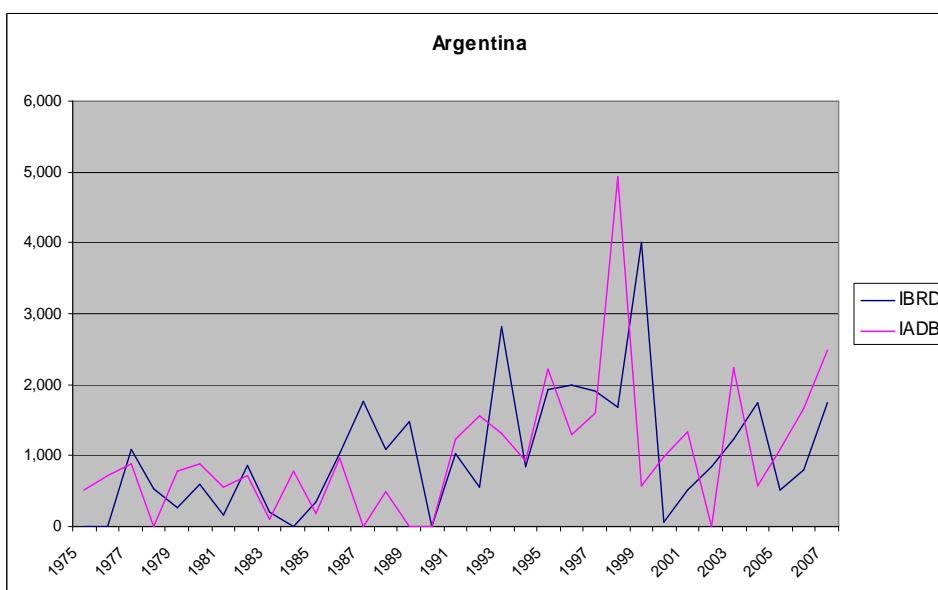
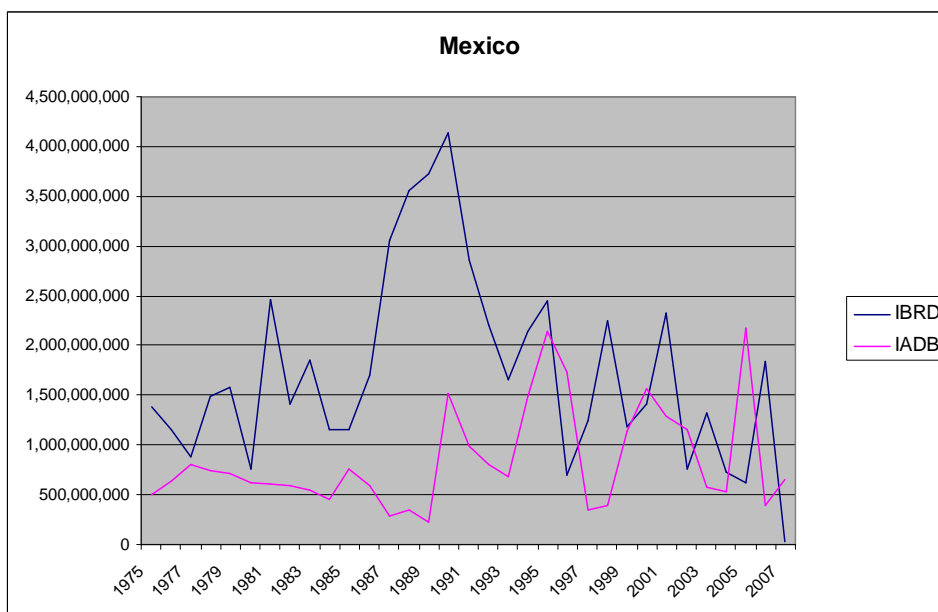
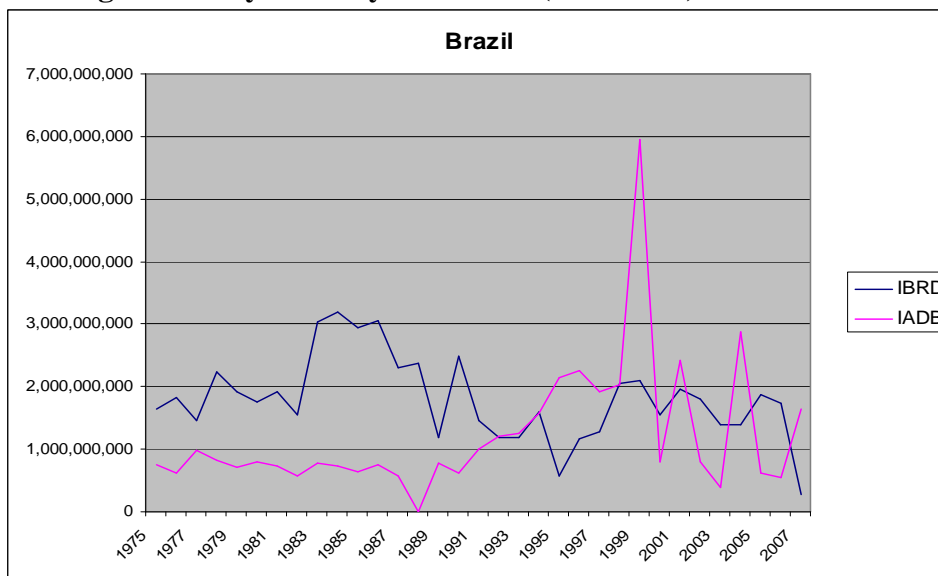
- Cost of MDB loans (interest rate)
- “Hassle factor” of MDB loans
- Loan conditionality (only relevant on policy-based loans from IADB and World Bank)
- Political preferences of government
- Political preferences of MDB
- Perceived default risk of government
- Resources available to lend by MDB

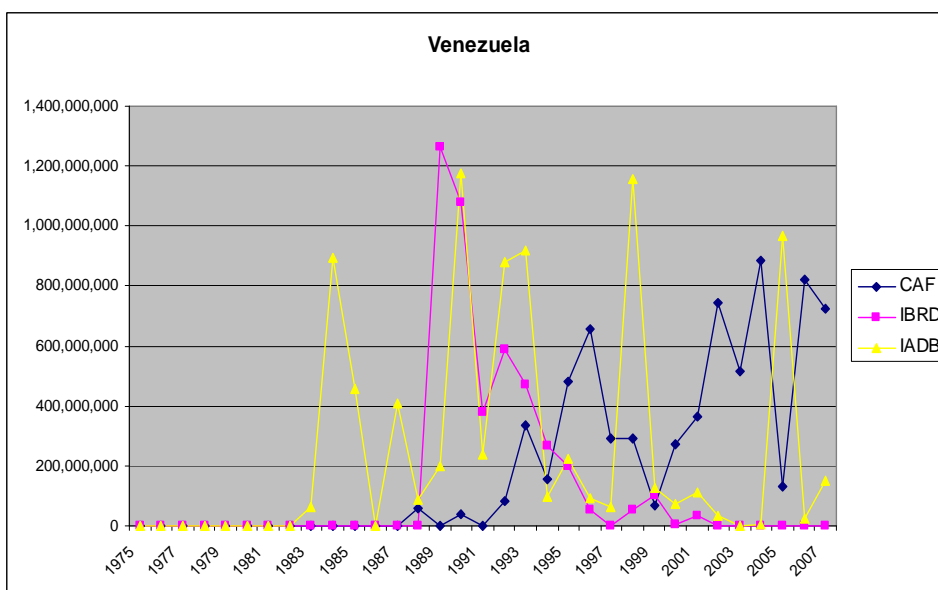
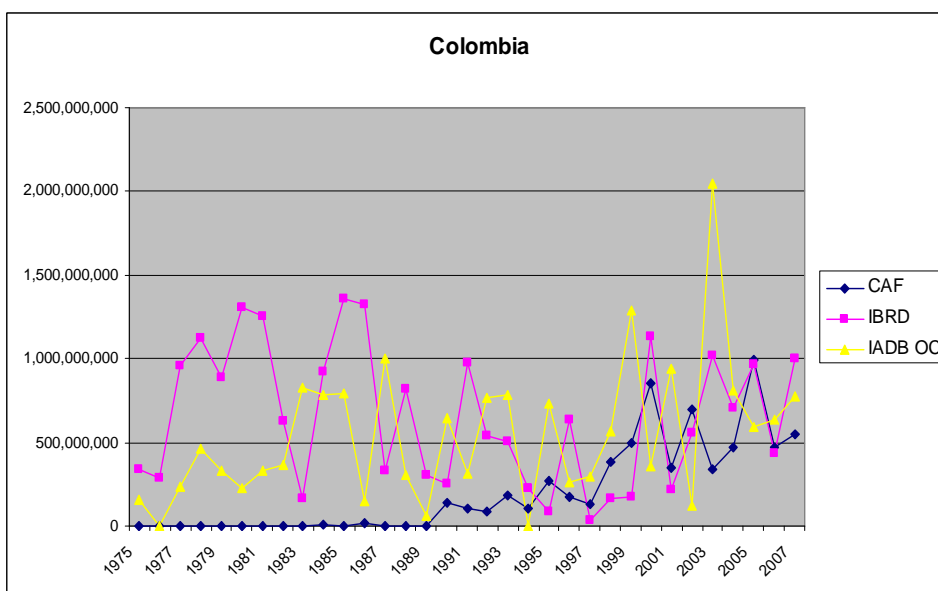
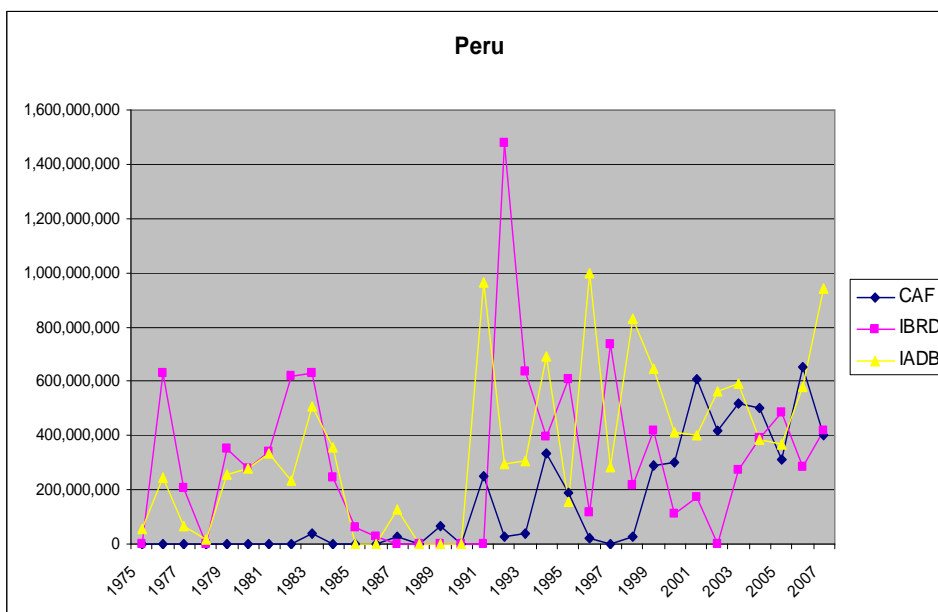
This list is not exhaustive, but provides some notion of the issues that most logically seem to be involved in determining whether a country borrows money from an MDB. Many will require proxies to operationalize in a regression.

Any reactions to this methodology proposal are most welcome.



## Lending Trends by Country 1975-2007 (2007 USD)





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