Has the World Bank Lost Control?

by Adam Lerrick

> *"We are facing…competition [from the capital markets]. I think it's important that we effectively compete. Increasingly,…if the fight against poverty is successful, more and more countries will be in this middle-income category, and if this institution is going to remain relevant to the world, it obviously needs to be relevant to the middle-income countries."*
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> World Bank President Paul Wolfowitz, September 22, 2005

The World Bank is in big trouble. Major middle-income countries, the cream of the Bank's portfolio, are curbing their borrowing and paying down their balances, setting off alarms at the Bank. Net loan flows have shifted $30 billion over the last seven years, from positive to negative. Instead of drawing a net $14 billion from the Bank in 1999–2002, these nations repaid a total of $15 billion in 2003–2005. The cause is clear: The interest subsidy embedded in Bank loans, a compelling 12 percent per annum on average in 1999, has now shrunk to less than 2 percent as emerging nations have gained increasingly greater access to private capital. The difference is no longer enough to persuade finance ministers to realign their economic priorities with the social agendas of the Bank's rich members.

For years, the Bank has been in the business of lending at highly subsidized rates to non-needy nations. Ninety percent of Bank loans now go to just 27 borrowers, 10 of these accounting for 75 percent, a list that closely parallels private sector choices, and for these nations the Bank contributed a mere 1 percent of the average

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net $200 billion that the capital markets have provided each year over the last decade.

When the International Bank for Reconstruction and Development (IBRD) was founded and its self-image formed, capital markets were small, segmented and cautious. The Bank was to borrow in the markets, backed by the AAA guarantee of its rich industrialized membership, and lend on to developing countries that could not access resources to fund growth. International financial intermediaries to channel funds and assume risk were in short supply. The plan was for developing economies to be nourished only until they had gained the financial credentials to attract private capital on their own. This was called “graduating.” But the Bank won’t let go.

The Bank was enjoined from displacing the private sector. Now it wants to compete. With its monopoly power lost, the Bank is scrambling to maintain market share by lowering prices. In the end, it is the demands that are at the very center of its mission that will be sacrificed to maintain competitiveness.

Middle-income borrowers are clearly good for the Bank. The Bank wants to keep its best, lowest risk customers. Their loans are more likely to be paid and their projects more likely to succeed. Without these prime clients to raise the value of its portfolio, both its credit and its credibility would be challenged. And the Bank has been willing to pay for the privilege of “staying involved.” Over the past twelve years, IBRD loan revenues have fallen short of administrative costs by a cumulative $3 billion. Over time, more and more countries will move into the middle-income group that already commands two-thirds of World Bank Group money and effort.

But is the World Bank good for middle-income borrowers? The Bank’s litany of reasons for lending is refuted by the facts of the market place. Its premise of a shortage of private funding is no longer valid. Its business model that relies on subsidized financing is outdated. Its advice now has a negative value to its best clients. In a world of finite aid resources, its money and effort are better dedicated to the poorest nations whose access to private capital is in the distant future.

The global economy has out-distanced the need for World Bank lending to emerging nations and along the way has done more to alleviate poverty than all the interventions of officialdom. But if the Bank insists, and its rich members concur, that a First World vision should be imposed on a developing world and that the poor must be elevated whether they live in countries that cannot afford to pay or in countries that do not want to pay, it needs a new financial structure to match modern realities.

Six World Bank Pretexts for Lending

The Bank wants to remain "relevant" to the middle-income countries but its defense of lending as a means to "stayed involved" is rooted in the past and now refuted by the facts.

I. The Bank lends to countries without ready access to the capital markets

It is widely believed that the World Bank devotes the greater part of its effort to countries denied market financing. In truth, the Bank centers its portfolio on the most credit-worthy candidates, a broad overlap with the private sector that is specifically enjoined in its mandate.

A review of the Bank's lending over the last five years reveals that 99 percent went to countries with international bond ratings from an investment-grade A down to a high-yield/higher risk B. Approximately 25 percent of resources flowed to nations with an investment grade rating and an additional 74 percent to countries with high-yield ratings at the time of the loan. More disquieting, the share of IBRD loans to countries without international ratings has fallen from 40 percent in 1993 to 1 percent in 2001–2005. (See graph I.)

The Bank has contrasted the private sector's 70 percent concentration of flows to 10 countries with its own lending spectrum that channels resources to the entire developing world. However, a review of the major recipients of the IBRD's resources over the last five years reveals that 10 countries accounted for 76 percent of flows, while the remaining 69 borrowing members were left to divide only 24 percent.

These are the very countries that attract the bulk of private sector resources: Turkey (14 percent), Brazil (13 percent), India (10 percent), Mexico (9 percent), China (8 percent), Argentina (8 percent), Colombia (5 percent), Indonesia (3 percent), Romania (3 percent) and Russia (3 percent). (See chart I.) There are another 17 emerging nations with reliable access to the capital markets.[1] Added together, just 27 economies monopolize 90 percent of Bank lending.[2]

In total, the 10 major borrowers received $2 billion in net resources from the Bank over the past five years, or an insignificant 0.4 percent of the $580 billion originating in private sector medium- and long-term external debt, portfolio equity and direct investment.[3] (See chart I.)

II. The Bank lends where the developing world's poor live

As emerging nations have gained increasingly greater access to financial markets, the Bank has conjured up an alternate argument. It is the relative share in the developing world, whether by population, by economic size or by poverty that justifies the concentration of its lending in so few major emerging countries.

The numbers deny this claim. Six of the Bank's 10 leading clients annexed 52 percent of Bank loans over the past five years, yet only accounted for 10 percent of the total population and 24 percent of the GDP of IBRD-eligible borrowers. Their average per capita income of more than $8,000 on a purchasing power parity basis placed them in the top quarter of emerging nations. (See table I.)

III. The Bank lends for projects without interest to the private sector

A host government guarantee is required on all Bank loans. This displaces private sector lending dollar-for-dollar for any country with capital market access and renders the destination of proceeds irrelevant. When private lenders can look to the host government for repayment, as the Bank does, the capital markets are indifferent to end-uses. Whether the goal is financing vaccinations of Indians in the Amazon or nuclear weapons, prospectuses of sovereign bond issues simply state "general government purposes" as the use of proceeds.

IV. Bank lending is the sole source of funds for long-term development

The benefits of many projects accrue over long-term horizons and were once difficult to finance, even for countries with ready access to the markets. Now, the capital markets supply 20-year, 30-year and even 40-year financing, far beyond the Bank offer of amortizing-loans with final maturities of 15–20 years. During the past five years, 23 emerging World Bank borrowers have issued bonds in the market with maturities stretching into the future 25 years and more, well above the limits of Bank terms.

V. Bank loans are a counter-cyclical balance to volatile market flows

The specter of a sudden exodus by the private markets in times of financial stress in contrast to the loyal and steady flow of Bank funding is a timeworn argument. But counter-cyclical stabilization requires more resources than the Bank can muster. If private flows were to collapse by 50 percent, Bank loans would still represent less than 1/50th of the total capital moving into middle-income economies.

The global marketplace is remarkably resilient. Within three months of the 1997 Asian crisis, Korea obtained $4 billion in the capital markets with medium-term maturities. When Brazil faltered in 1998, the next three months counted 20 issues totaling $12 billion for Latin American sovereign borrowers with maturities of 5–20 years. There was even a $2 billion issue for Brazil itself.

A constant stream of lending in anticipation of the off chance of a temporary fall in private sector flows cannot be justified. When and if a crisis threatens, official funds can be mobilized, but this is outside the mandate of a development institution.

VI. Bank lending to emerging countries generates profits to subsidize poor nations

Regardless of credit risk, the Bank charges the same interest rate to all borrowers, equal to the Bank's own cost of funding in the capital markets, plus a spread of 0.50 percent per annum.[4] This spread, when added to commitment and up-front fees, is claimed to cover the administrative costs of running the Bank and make a profit that is passed on to the poorest nations. Far from generating a surplus for the poor, lending is draining resources. When all is accounted for, the Bank loses money on its loans. For the past 12 years, annual deficits of $100–500 million have resulted in a cumulative loss from lending of $3.2 billion. (See graph II.)

In truth, the Bank earns its net income by using its $40 billion of zero-cost capital.[5] This pool of cash generates between $1.5 billion and $2 billion per annum, depending on the level of interest rates. And this net income is the same whether it is lent to Bank borrowers or simply placed in a portfolio of 10-year U.S. Treasury notes.

The record reveals that the Bank's operating income is a function of the level of interest rates. It closely tracks the return on the Bank's zero-cost capital invested at the 10-year U.S. Treasury rate, adjusted for other income and expense. (See graph II.) If the operating income were derived from the spread on Bank loans, the return would be constant, whatever the fluctuations in U.S. Treasury rates.

Bundling Advice and Loans: An Outdated Business Model

Doing business with the Bank is not just about money. Lending has always been a two-part package. There is a loan at highly subsidized rates, historically 7–10 percent per annum below the market. Clearly a gift. And then there is the "technical assistance" which the Bank insists is highly valued and the very reason clients borrow from the Bank. In short, another gift. Yet the Bank contends that borrowers will not follow the advice unless it is partnered with subsidized loans.[6] At first hearing, all this defies logic and common sense. If the Bank's advice is truly "assistance," why do borrowers insist on being paid to comply?

Translated, this Bankspeak is really about imposing a First World social vision upon an emerging world intent on growth. If the environment must be safeguarded, if workers must be protected, if women must play an equal role, if indigenous peoples must be empowered and if the overriding focus must be on the poor, the trade-off has a cost.

Bundling really means that emerging nations are being paid to execute projects low on national priorities, and that they are being paid to implement projects in a manner that imposes large costs, not just in money but in time and effort, that arms-length market funds do not demand. For decades, finance ministers of developing countries have sat at the table and listened—after all, they were being paid millions of dollars per hour in subsidies to attend the lecture.

But in the past decade, three independent trends have converged to destroy the attractiveness of Bank loans: international capital markets expanded and became willing to take on the risks inherent in developing economies; emerging nations became stronger as sound policies elevated their credit status; and nongovernmental organizations (NGOs) were invited by the Bank to step inside the development aid process as anointed spokespersons for civil society. There are now some 20,000 highly vocal NGOs with a multiplicity of demands that have led the Bank to slight the infrastructure needs high on borrower plans for growth in favor of "social programs" without clear economic yield, and to impose elaborate standards that raise the cost of compliance beyond practicality.

Bank "Advice" Has a Negative Value

Do borrowers come to the Bank for the advice or for the subsidy? Now the facts are in and the debate is ended.

Since 1999, the subsidy in World Bank loans to major emerging market governments has fallen from an average 12 percent per annum to less than 2 percent per annum, as measured by the JP Morgan Emerging Market Bond Index.[7] At the same time, the net borrowing by these nations from the Bank has collapsed from a positive $14 billion in 1999–2002 to a negative $15 billion in 2003–2005. (See graph III.) First, borrowing slowed; then countries moved on to repay loans. The interest rate differential is no longer enough to persuade finance ministers to realign their economic priorities with the social agendas of the Bank's rich members.

When it all adds up, the Bank's "technical assistance" has a negative value to its traditional client states. A new generation of government officials, with PhDs from MIT and Chicago, has done the arithmetic. Borrowing patterns reveal that they rated the cost of Bank "advice" at 3–4 percent per annum. Over time, that amounts to 25–35 percent of loan expense. When the interest subsidy fell below the cost of World Bank compliance, the real subsidy vanished and so did the borrowers. (See graph III.)

The conclusion: For years, World Bank loans have been funding projects that countries didn't think were worth financing out of their own resources or worth the cost of borrowing at a market interest rate. Borrowers are willing to pay the markets 3–4 percent more as the price of independent choice.

The Bank Is No Match for the Markets

The Bank was created to fill a void in the international financial system. Resources and a willingness to assume risk were needed to fuel growth in the developing world. The private sector has now preempted the Bank's role of financial intermediary to emerging nations and is far better at it than the Bank can ever hope to be. Yet the Bank is clinging to its past.

Its traditional tools can no longer deliver the subsidy that keeps it in the game. There is little wiggle room in the 0.50 percent annual charge, 0.25 percent commitment fee and 1 percent up-front fee the Bank adds to its cost of raising money to cover its own expenses. When all costs are counted, the Bank is already losing money on its lending. Cutting down on the burdens of the bureaucratic "hassle factor" will have a minimal impact on the "price" of its loans.

To counter the competitive threat of the private sector, the Bank is ready to abandon the protections that have served it well for decades and to search for innovative financial instruments in the marketplace. But the effective cost of Bank resources to its clients can never be lower than its own cost of funds.

How to lower lending rates? How to assume more risk? How to invent new instruments? These are all the wrong questions. Abandoning the sovereign guarantee, lending to sub-national entities, substituting guarantees for loans, securitizing pools of loans and adding what Wall Street calls the "nuclear waste" to the Bank's portfolio. These are all the wrong answers. Even the most convoluted mechanisms to embed subsidies in new instruments will only lead to hidden but ever-increasing costs for the Bank. And the only outcome will be a growing exposure to risk without compensation to cover losses.

The Bank is rational to consider risk lightly for it is well placed to hide failures in ways that might put a private sector institution out of business and its management behind bars. But the Bank has no regulators. Its skills of concealment were honed in the poorest economies where, for two decades, a system of "defensive lending" miraculously matched the dates and amounts of repayment schedules to "new" loans, creating a perpetual roll-over of defaulted debt. In the end, it was the Bank's rich members that assumed the losses of "debt relief" and restored the Bank's balance sheet.

When the Bank steps out of its protected bailiwick, it is skilled private investors who will profit from the Bank's learning experience. Failures to make allowance for risk in a futile effort to defend market share will be quietly covered up. Bad loans will be hidden and rolled over. Effective resources will be diminished. An invoice for the losses will again be delivered to G7 taxpayers.

The Irrelevance of Lending

The Bank is no longer in a world short of capital. World Bank lending is clouding the landscape and wasting resources. All that the Bank really contributes in a world of sophisticated financial markets is the subsidy that fills the gap between the real cost of projects and what recipients are willing to pay.

As the ratings of middle-income countries climb and their cost of market funds falls, the Bank is being forced to seek the help of other donors to recreate the subsidy once provided by its loans. A pioneering project: The Bank is building schools in China's impoverished Western provinces but the bill for interest charges is being mailed to the United Kingdom, attention Chancellor of the Exchequer Gordon Brown.

China is awash in money. There are $700 billion in foreign reserves stored at its central bank and foreign direct investment adds $60 billion each year to the economy's resources. Because the government can borrow in the markets at a lower cost than from the Bank, and because the Bank is more intent on aiding China's poor than China, the U.K. Treasury agreed to pick up the interest tab on the China loans. In 20 years, when China has paid back three loans totaling $300 million, its cost will have been 55¢ on the dollar. All that China really received and wanted was $12 million in annual subsidies, not $300 million in loans.

If poor children are benefiting, where's the harm? There's no harm if global aid resources are infinite. But the Bank's effort to retain influence with middle-income countries siphons off scarce funds from the poorest. There is also potential for harm if Bank loans free up prospering nations to pursue other ambitions, perhaps nuclear weapons or locking up access to natural resources abroad. (Iran has been the Bank's 10th largest borrower and China the 3rd largest over the last three years.)

If the Bank insists that the poor must be elevated whether they live in countries that cannot afford to pay or in countries that do not want to pay, if it wishes to promulgate costly programs that are of marginal interest to borrowers in the name of a freely interpreted version of global public goods, more and more donor funds will be required to restore the subsidy in Bank loans.

An unsustainable business model must be replaced with a new financial structure that matches modern realities. Lending is a blunt and inefficient instrument. The price of persuasion should be at lowest cost. Subsidies can be individually tailored according to the market borrowing cost of governments and the priority the government places on each project.

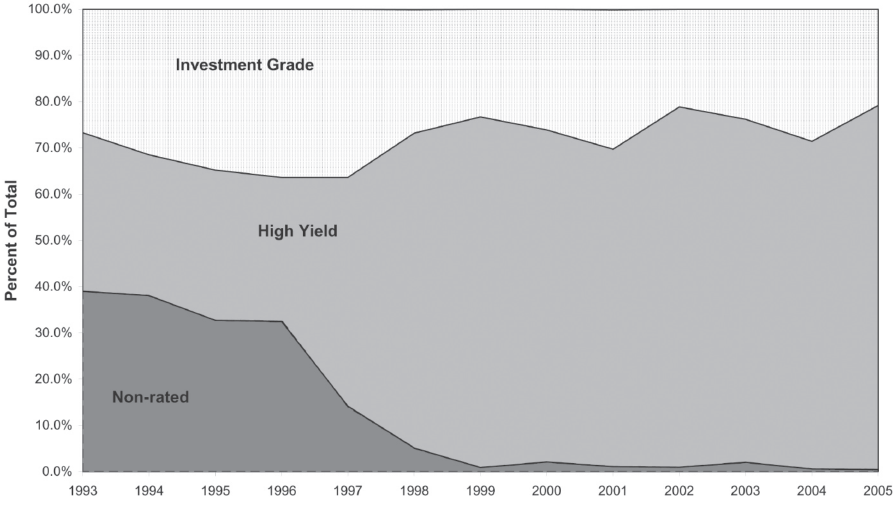
There is already $40 billion of zero-cost capital on the Bank's balance sheet as a starting point to endow a permanent foundation that would be invested in the capital markets to generate a stream of subsidies. These would underwrite interest payments on country borrowing in the markets. Over time, rich countries may be asked to contribute more funds.

Otherwise, as more emerging nations move up the credit ladder, donors will be compelled to divert an ever-increasing share of their own aid funds to enhance the appeal of Bank loans. The experiment begun in China will be the prototype as Mexico, Brazil, Chile and others line up for the same deal.

Mechanics should not be confused with the mission. The Bank must accept that it is in the development business, not the banking business. Long ago, they may have been one and the same, but now there are better ways to deliver resources to what the Bank perceives as its real clients, the global poor, and to foster global public goods. If the Bank continues to fight the tape, it will become irrelevant to the purpose for which it was designed.

Graph I

World Bank Loans: 99% to Countries with International Bond Ratings*



Sources: World Bank, Moody's Investors Service, Standard & Poor's

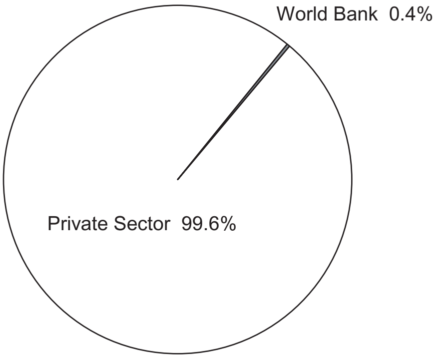
*IBRD loans excluding Iran.

Chart I

Insignificant to its Major Clients:
World Bank versus Private Sector: Net Flows 2001-2005

Ten Leading World Bank Borrowers

Turkey	14.3%
Brazil	13.0%
India	10.2%
Mexico	8.8%
China	8.2%
Argentina	7.5%
Colombia	5.4%
Indonesia	3.3%
Romania	2.9%
Russia	2.8%
Total	76.4%



Sources: World Bank, Global Development Finance 2005

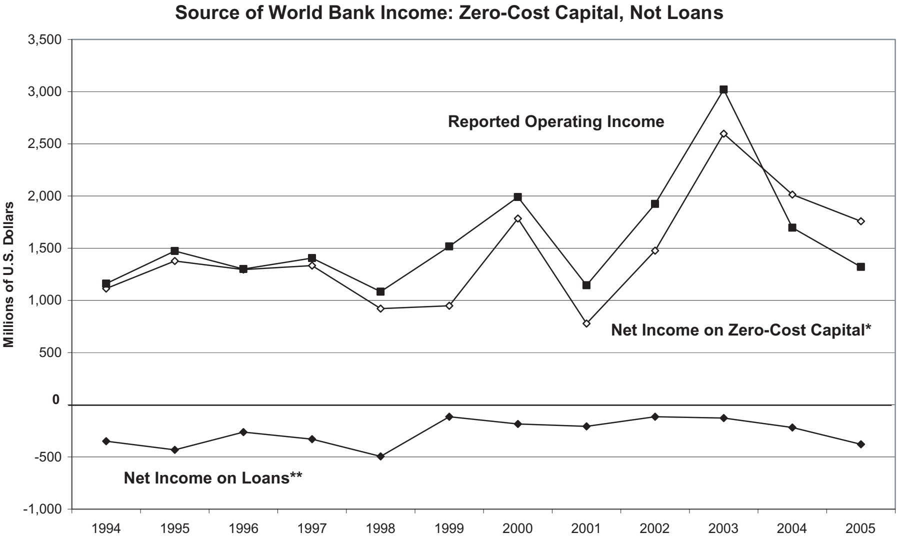
Table I

Six Leading World Bank Borrowers: Bank Loans versus Population, GDP, and Poverty

	% of IBRD Loans 2001-2005	% of IBRD-Eligible 2003 Population	% of IBRD-Eligible 2003 GDP	2003 Per Capita Income (PPP)
Turkey	14.3%	1.6%	3.0%	$6,710
Brazil	13.0	4.1	7.2	7,510
Mexico	8.8	2.3	9.6	8,980
Argentina	7.5	0.9	2.1	11,410
Colombia	5.4	1.0	1.2	6,410
Romania	2.9	0.5	0.7	7,140
Total/Average	**51.9%**	**10.4%**	**23.8%**	**$8,027**

Sources: World Bank, World Development Indicators 2005

Graph II



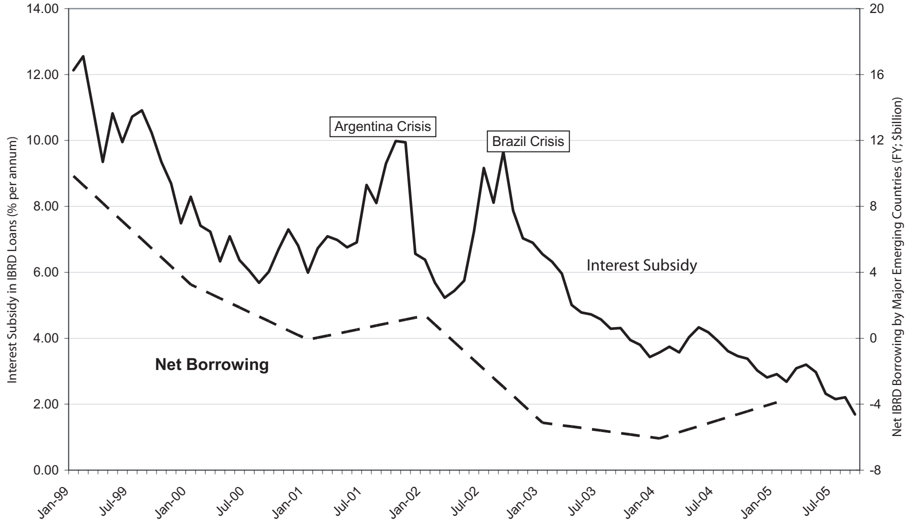
*Estimated based upon the 10-year US Treasury interest rate and adjusted for changes in provisions for loan losses, contributions to special programs, net loan income, arbitrage income and other income to ensure comparability to reported operating income.

**Interest spread income plus commitment fees plus up-front fees on IBRD loans minus IBRD administrative expense.

Sources: World Bank, Federal Reserve Historical Data

Graph III

World Bank and Major Emerging Countries:
Falling Subsidies; Falling Loans



Sources: World Bank, JPMorgan

Notes

1. Bulgaria, Chile, Costa Rica, Ecuador, Egypt, El Salvador, Korea, Malaysia, Morocco, Peru, Philippines, Poland, Slovak Republic, Thailand, Tunisia, Uruguay and Venezuela.

2. Within the middle-income group, there are 52 mostly small economies that may rely on official financing in times of stress. Though significant in number, these nations received only 9 percent of Bank loans over the past five years and account for only 8 percent of developing world population.

3. These figures underestimate the quantity of private sector inflows because the substantial foreign investment in domestic bonds is not included in the data.

4. The interest spread charged on Bank loans was 0.25 percent in 1994–1998, 0.45–0.50 percent in 1999–2000 and 2002–2005, and 0.35–0.50 percent in 2001. In addition, the Bank charges a commitment fee of 0.25 percent and, from 1999, instituted an up-front fee of 1 percent.

5. As of June 30, 2005, the Bank's $39 billion zero-cost capital was comprised of $11.5 billion in paid-in capital and $27.2 billion of retained earnings.

6. Another justification for the bundling is that loans are concrete proof of the Bank's confidence in its own counsel. But the sovereign guarantee on Bank loans divorces project results from the risk of loss. Whether the advice is good or defective, whether the project succeeds or fails, the borrower must repay the Bank.

7. A composite of 19 leading emerging market sovereign borrowers.