American Enterprise Institute for Public Policy Research

November 2005

On the Issues

Why Is the World Bank Still Lending?

By Adam Lerrick

The World Bank should be restructured in order to meet the development needs of the poorest countries it was originally designed to assist.

World Bank money 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 Exchequer Gordon Brown. Mexico, Chile, and Brazil will soon be lining up for the same deal.

This is but the latest scheme designed to preserve the World Bank's lending role at a time when the need and demand for its services are falling. Major middle-income countries, the cream of the bank's lending portfolio and where more than 80 percent of Latin Americans live, are curbing their borrowing and paying down their balances, setting off alarms at the bank. Net loan flows have shifted from a positive $10 billion in 1999–2001, to a negative $15 billion in 2002–2004.

The cause is clear: the interest subsidy embedded in bank loans, a compelling 12 percent per annum in 1999, has now shrunk to less than 2 percent on average 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.

Doing Business with the Bank

The cost of doing business with the bank is not just about money or about the burdens of the bureaucratic "hassle factor." There is also the "technical assistance," which the bank has always insisted be tightly bundled with subsidized loans. Translated, this bank-speak is really about imposing a first-world vision upon an emerging world. The environment must be safeguarded, workers must be protected, women must play an equal role, indigenous peoples must be empowered, and the overriding focus must be on the poor.

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 Ph.D.s from MIT and Chicago, have done the arithmetic. Borrowing patterns reveal that they rate the cost of bank "advice" at 3 to 4 percent per annum. Over time, that amounts to 25 to 35 percent of the loan expense. When the interest subsidy falls below the cost of World Bank compliance, the real subsidy vanishes and so do the borrowers.

When the World Bank (officially the International Bank for Reconstruction and Development) was founded and its self-image was formed, capital markets were small, segmented, and cautious. International financial intermediaries to channel funds and assume risk were in short supply. The plan was for the bank to borrow in the markets, backed by the AAA guarantee of its rich industrialized membership, and lend to developing countries that could not otherwise finance growth. Developing economies were to be nourished only until they had gained the financial credentials to attract private capital on their own. This was called "graduating."

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Borrowing by Middle-Income Countries

Today for the twenty-seven borrowers that receive 90 percent of its loans, the bank represents less than 1 percent of the net flows of $200 billion that the capital markets provide each year. But the bank will not let go.

Middle-income borrowers are clearly good for the bank. Loans are more likely to be paid and 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. But is the bank good for middle-income borrowers?

With its monopoly power lost, the bank is struggling to maintain market share by lowering the costs to borrowers. There is little wiggle room in the 0.75 percent annual charge the bank adds to its cost of raising money to cover its own expenses. Now the bank seems poised to abandon its conservative strictures and to search for innovative financial instruments in the marketplace. No matter how convoluted the structure, 0.75 percent per annum is the limit, and the result will be more risk without remuneration for the bank. At the same time, it is cutting down on the social demands that are the very reason for its lending.

As more middle-income countries achieve investment grade ratings, the experiment that began three years ago in the hill country of China may be a prototype. China is awash in money. There are $700 billion in foreign reserves stored at its central bank, and foreign direct investment adds $65 billion each year to the economy's resources. Because the government can borrow in the markets at a lower cost than from the bank, the UK Treasury agreed to restore the World Bank subsidy by picking up the interest tab on the China loans. In twenty years when China has paid back three loans totaling $300 million, its cost will have been 55 cents on the dollar, courtesy of Gordon Brown.

Assisting the Neglected Poor

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.

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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 provides in a world of sophisticated financial markets is the subsidy that fills the gap between the real cost and what recipients are willing to pay. All that China really received and wanted was $12 million in annual subsidies, not $300 million in loans.

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, it needs a new financial structure to match modern realities. There is already $40 billion of zero-cost capital on its balance sheet that could endow a permanent foundation and generate a stream of individually tailored subsidies that would replace loans yet provision the greater part of the $100 billion of programs the bank presently underwrites.

Purposes should not be confused with mechanics. 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 mission for which it was designed.