The Role of World Bank Lending in Middle Income Countries

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I will focus my comments specifically on the role of World Bank lending in middle income developing countries (MICs).[1] I will make six interrelated points:

- There has been a substantial decline in World Bank lending to MICs.
- MICs still face a significant development challenge.
- The declining role of the Bank lending is a problem for the MICs and the Bank.
- There are many reasons for the decline in Bank lending to MICs.
- There is good news as some progress has been made to facilitate lending to MICs.
- There is still much that can and needs to be done.

1. There has been a significant decline in World Bank lending to MICs.

For Fiscal Years 1990-97[2] lending by IBRD fell in the range of $15-18 billion. After a dramatic, but brief spike in lending in response to the East Asia financial crisis, IBRD lending dropped to about $10-11 billion during FYs 2000-2003. This decline took place in all regions, except South Asia, and in all sectors, except education and health. The drop was particularly dramatic for infrastructure and financial intermediation loans[3] and affected especially lending for investment projects (as against balance of payments and budget support loans), for which lending roughly halved when comparing the same periods (from about $12 billion to $6 billion). The decline in lending was found in both well and badly performing countries. It occurred at a time when private capital flows to MICs collapsed and while the lending by regional development banks (such as the Asian Development Bank, the European Bank for Reconstruction and Development, and the Inter-American Development Bank) expanded.

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* The author is a Visiting Fellow at the Brookings Institution. For the comments I draw on my four-year engagement as the World Bank's vice president for financial policy and risk management and on my eight-year experience as the Bank's vice president for the Europe and Central Asia Region. I also draw on my involvement in two internal World Bank task forces which during the last three years assessed the Bank's role in middle income countries. The factual evidence cited draws on the work of these task forces. The positions I advocate here are consistent with those I have advocated as a member of these taskforces. The views expressed in these comments are entirely my own, and should not be seen to represent views of the World Bank or the Brookings Institution.

[1] As is commonly done in analyses of World Bank lending trends, I equate middle-income countries with countries borrowing from the International Bank for Reconstruction and Development (IBRD).

[2] The World Bank's fiscal years (FY) run from July 1 through June 30.

[3] Financial intermediation loans are loans to banks in borrowing countries, which in turn lend on these funds to final borrowers.

Why would one worry about this declining trend in World Bank lending to MICs? Isn't it a good thing if the Bank works itself out of a job in countries which, one might think, should in any case stand on their own feet?

2. MICs still face significant development challenges.

About 80% of the population of developing countries lives in MICs and 70% of the poor people in developing countries live in MICs. In addition to poverty, MICs face many important development challenges:

- significant shortfalls with regard to the potential to achieve the Millennium Development Goals
- vulnerability to macroeconomic and financial crises
- serious weaknesses in the private investment climate and public governance
- shortages of physical and social infrastructure
- high rates of unemployment and social security systems that are under stress
- vulnerability to environmental damage and natural disasters

These challenges affect not only the wellbeing of the people in the MICs, but also carry major world-wide risks which endanger the wellbeing of people in the industrial countries as well as in the low income countries. These risks include:

- global macroeconomic imbalances and financial instability
- global political instability
- migration
- global environmental damage

3. The declining role of the Bank lending is a problem for the MICs and the Bank.

Many MICs need the Bank's financing to help address these challenges:

- After the East Asia crisis, net private financial flows to MICs turned from an average annual inflow of about $140 billion per year during the 1990s to zero or negative flows in the early 2000s. In late 2003 over 1/3 of 82 IBRD borrowers had no market access at all, and most of those who did have some access had to borrow at spreads that typically ranged from 100 basis points (BP) to over 500 BP, compared with about 40 BP that IBRD borrowers usually way on World Bank loans.

- It is standard practice in the industrial countries to channel sizeable financial flows to backward regions in order to support convergence in regional production and incomes. This holds for the structural and cohesion funds in the European Union and is a very common characteristic for intergovernmental transfers from the national to regional and local authorities within industrial countries. The very same rationale applies to channeling funds from industrial to developing countries, including the MICs, whose per capita income still amount to as little as 10% of the per capita income of a typical industrial country.

- The World Bank's package of financial and advisory support through its IBRD loans (along with its free-standing analytical and advisory services) is in principle well suited to support the structural and institutional changes along with investments in physical, social and environmental infrastructure that are needed in the MICs.[4]

For the Bank and its shareholders the decline in IBRD lending carries a number of serious risks:

- The Bank's role as "transmission belt" carrying low income countries through middle income status into the ranks of higher income countries will be at stake. This is somewhat ironic, since the on balance the Bank has probably been more successful in helping middle income countries than low income countries.[5] Part of the "transmission belt" function of the Bank is to convey the lessons of MIC development experience to the low income countries.

- The ability of IBRD to continue making sizeable contributions to the Bank's soft-loan and grant window, IDA, and for transfers to the debt reduction initiative for the poorest heavily indebted countries will be endangered since these financial windows are financed in part from the income generated by INRD loan charges. This would mean a sizeable reduction in financial flows to the poorest developing countries.

- If the Bank is no longer seriously engaged in supporting MICs, its role as a global development organization that helps address global economic, social and environmental challenges on a world-wide scale will be at risk. There is currently no other organization that can perform this function credibly.

4. There are many reasons for the decline in Bank lending to MICs.

The decline in Bank lending to MICs reflects a complex mix of factors at the country level, at the sector level and in terms of the Bank's own attitude and procedures.

At the country level, various factors have caused a reduction in MIC borrowing: Some MICs have formally or informally graduated from IBRD lending, as has been the case with some Central European countries. Others have dropped from IBRD to IDA borrower status due to financial and economic crisis and mismanagement (Indonesia, Nigeria). Others have high oil revenues and hence temporarily little need for external borrowing by the government (Kazakhstan, Russia). Some are constrained by severe limits on their ability or willingness to service loans due to financial crisis (Argentina), and in yet other

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[4] This is in contrast to the situation in the low income countries, where grants may be a more appropriate way of providing financial assistance, esp. for the poorest and most debt-ridden developing countries.

[5] There are of course important exceptions: China, India, South Korea and Turkey at one time were IDA-only borrowers, but now have either graduated from IDA (and even IBRD) borrower status or have moved into IBRD/IDA blend status.

cases the Bank's strict exposure limits constrain lending to high-risk or high-exposure countries.

At the sector level, there has been a particularly severe decline in infrastructure and financial intermediation lending. This is due to a number of factors:

- During the 1990s there has been a deliberate shift away from physical infrastructure and financial intermediation lending towards lending for social sectors on the grounds that the private sector can be relied on to finance infrastructure and financial services, and that social sector spending contributes more directly to poverty reduction. Recent experience has shown that private sector financing for infrastructure is often not sustainable even in the MICs and that banking institutions in MICs are not equipped to intermediate adequate financial resources for private investment. The importance of these sectors for supporting economic growth, employment and poverty reduction in MICs has now therefore once again come into focus.

- Constraints of excessively rigorous and demanding fiduciary and social/environmental safeguards attached to Bank projects has slowed down Bank lending and increased its effective cost to borrowers. Fear of running afoul of such stringent requirements and the ensuing sanctions both inside and outside the institution also has encouraged to risk-averse behavior among Bank staff and management. These factors help explain in particular the reduction in investment lending.[6]

- There has been a decline in skilled project staff in the Bank's regional operational units, which can be explain in part by an overall reduction in staff numbers, by a shift of staff to fiduciary, safeguards and quality management functions, and by a shift of senior staff to central sector units engaged away from frontline operational work.

- In contrast to some of the regional development banks, the World Bank is constrained from lending to sub-national governments, since it always requires a sovereign (national government) guarantee on its loans and traditionally has been able to make only foreign-currency denominated loans (which are not well suited for lending to sub-national governments which generally cannot effectively manage currency risk). As the Bank has encouraged its client countries to decentralize and strengthen sub-national government capacities, its own lending practices have prevented it from

[6] Sebastian Mallaby in his newly published book The World's Banker (New York: The Penguin Press, 2004) argues that this in large part due to inappropriate pressures by northern advocacy NGOs. See also his article in Foreign Policy (September/October 2004, pp. 50-58) entitled "How NGOs Hurt the Poor." More generally, the position taken in my comments here are closely in line with those by Sebastian Mallaby expressed in regard to the constraints and risks which the Bank faces in its lending to MICs. I read his book with great interest after making my own comments on October 4, 2004 at the OED conference.

supporting a corresponding shift in loan commitments to sub-national authorities.

Finally, there have been some fundamental attitudinal factors at work: During the 1990s and into the new millennium, the Bank shifted its focus from seeing itself primarily as a financial institution providing loan services, albeit combined with high-quality advice, to consider itself as an institution providing principally development knowledge and advisory services and engaging in development advocacy especially for the world's poorest countries and for related global causes. At the risk of drawing a bit of a caricature, one might conclude that the institutional culture has moved from a focus on the "business of lending" to one which focuses more on the functions of a "knowledge bank" and "development advocate." At the same time lending has become mostly restricted to the dual role of a "crisis lender" alongside the IMF and of a "development finance boutique" which finances only the highest-quality projects while minimizing risks at great costs to the borrower and the Bank. This tendency was reinforced by the externally imposed need to perfect the loans, maximize policy conditionality and minimize risks (both the risk of project failure as well as country risk). It was reinforced by the Bank's organizational matrix structure in place since 1997 which permits the "churning" of project design and approval decisions as many units have an opportunity and even incentive to stop a project from going forward. Whatever the reasons, there is no doubt in my mind that during the 1990s the incentives for staff and managers in the operational departments were biased clearly towards lending less and more slowly, rather than lending more and faster.

It is notable that some of the principal regional development banks (e.g., the EBRD and the European Investment Bank, EIB) have had very different priorities, processes, procedures and attitudes, which have enabled them to maintain or even expand their lending to MICs at a time when the World Bank's lending has declined.[7]

5. There is good news as progress has been made to facilitate lending to MICs

The good news is that the Bank's senior management has recognized the challenge posed by the declining trends in lending to MICs and has begun to address it seriously. There have been two recent management and Executive Board reviews of the issues and possible solutions and some progress has been made in addressing some key constraints:

- There is now a clear managerial focus on setting stretch targets for lending and monitoring the delivery of loans not only in terms of quality, but also in terms of amounts and timing.
- A programmatic approach to lending allows more flexible and scaled-up support that combines budget support loans, sector-wide investment loans (SWAPs) and advisory work in individual sectors over longer periods of time.
- Efforts have been underway for some time to simplify and streamline loan procedures, reduce the cost of fiduciary and safeguards requirements, and encourage some transparent and justifiable risk taking in project design.

[7] One of the reasons is that these banks were less of a target for NGO pressures. See Mallaby, op. cit.

Improvements in and increased reliance on local fiduciary and safeguards systems are now pursued in MICs. This builds local capacity and facilitates speedy World Bank lending.

- There is now a clear effort to revitalize traditional lines of lending, especially for infrastructure programs.
- More flexibility is being introduced into the way managers can adapt the lending envelopes embodied in the country assistance strategies approved by senior management and endorsed by the Executive Board.

6. **There is still much that can and needs to be done to ensure responsive and dynamic Bank lending to MICs.**

The steps taken to date give one a sense that a turning point has been reached and that the pendulum, which had moved too far against lending, is beginning to swing back towards a more sensible position.[8] But I believe more can and needs to be done to ensure that the constraints and risks which the Bank faces in supporting the legitimate needs of its MIC shareholders are adequately addressed. The following list contains some proposals which should urgently be considered and implemented by the Bank's management and Board:

- Make sure to keep the attention of the Bank's senior management, its Board and its stakeholders on this high-priority matter – strongly advocate for a "sunrise" rather than a "sunset" role of the Bank in MICs!
- Be ready to learn from others, especially some of the dynamic regional development banks, such as EBRD and EIB – the next three recommendations reflect areas where these banks have been more active in maintaining or expanding their lending to MICs.
- Expand the scope of financial intermediation lending.
- Adapt the instruments for lending to sub-national governments, by introducing options for local currency lending and lending without sovereign guarantees.
- Integrate the lending activities of the World Bank and the International Finance Corporation (IFC, which lends to and provides equity to private investors) under the direction of World Bank Group country directors. This will allow for a more effective and flexible response of the Group to the needs of its MIC clients.
- Staff up the front-line regional units with senior sectoral, technical experts by shifting resources out of central units to the operational front lines..
- Ensure full implementation of project simplification directives (including the reduction of policy conditionality in investment loans, the adoption of programmatic and sector-wide lending approaches, streamlined fiduciary and safeguard administration, etc.).
- Introduce more flexibility and risk taking in the allocation of country lending envelopes reflecting IBRD's development mandate and superior financial risk taking capacity.
- Reduce or eliminate the IBRD's front-end fee for low-risk borrowers.

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[8] I am indebted to Sebastian Mallaby for the image of the "pendulum swung too far" which he expressed at a seminar organized by the Center for Global Development in Washington on October 2, 2004.

- Finally, and perhaps most importantly look at all proposed organizational and procedural changes through the eyes of a MIC borrower and make a judgment whether a proposed action really makes the Bank more attractive to the borrower as against merely shifting around the internal procedural deckchairs.

Concluding Remarks

In short, the role of the World Bank in MICs is as essential as it is has been threatened in recent years. It is urgent that the initial steps taken by the Bank's management and Board be maintained and reinforced. The pendulum had clearly swung too far from "pressure to lend" in the 1970s and 1980s to "pressure not to lend" during the last 10 years.[9] In doing so, one needs to be aware of the possibility of the pendulum swinging too far again in the opposite direction risking a loss of hard-won gains of improved quality and of the Bank's enhanced focus on social and environmental aspects of programs and projects. But at the moment the Bank is more at risk that it might fail supporting and enhancing worthwhile projects and programs in MICs than it is at risk of lending too much with too little safeguards.

I believe that the Bank's Operations Evaluation Department can be part of this momentum of change by focusing not only on the narrow questions of "quality" of Bank financed projects and programs, but by also considering more broadly whether the Bank is delivering effectively on its broad mandate of a development finance institution in the MICs. In this regard, one key performance criterion should be whether the Bank takes sufficient financial risks and adequately applies its considerable financial resources in support of its MIC clients' development aspirations and in support of the global development objectives of all its shareholders.

[9] The once exception to this trend was the temporary pressure by the G-7 on the Bank's senior management to engage in high-stakes crisis lending with exceptional and exceptionally large balance of payments support loans in the immediate aftermath of the East-Asia crisis of 1997/8. If anything this further weakened the Bank's capacity for delivering its line of standard investment and sector loans for long-term development programs.