The Agenda for Global Institutional Reform: Next Steps for Developing Countries

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The international financial system and developing countries

The Case for a Role for Multilateral Development Banks in Middle-Income Countries: A Reply to Meltzer by Prof Stephany Griffith-Jones

1. Introduction

The Meltzer Report argues that "the advent of deep global capital markets, willing to bear risk and prepared to channel substantial resources to emerging economies, has destroyed the rationale for much of the costly financial intermediation function that has been the (multilateral) Banks' main activity".

Based on this simplistic and incomplete diagnosis, the Meltzer Report recommends that:

"All resource transfers to countries that enjoy capital-market access (as denoted by an investment-grade international bond rating) or with a per capita income in excess of (US$4,000 would be phased out…. Starting at US$2,500 (per capita) levels, lending would be limited"

Table 1 lists all the countries that would be eligible for phase out from multilateral lending according for the Meltzer criteria. They include not only many of the major countries in Latin America and Asia (as well as South Africa), but also the largest country in the world, China.

This analysis and these recommendations are based on the incorrect assumption that, for those countries, private capital flows can and wish to replace totally lending by multilateral development banks' lendings, and that the private finance provided will be of equal quality to that of the multilaterals (in terms of maturity structure, volatility, etc).

Table 1: Effect of Country Eligibility Phase-Out

Countries with Investment Grade Rating (9/1/99)			Countries with 1998 Per Capita Income					
			above $2,500 Begin Phase-out			above $4,000 Complete Phase-out		
Asia	Latin America	Africa	Asia	Latin America	Africa	Asia	Latin America	Africa
China	Chile	Egypt	Malaysia	Belize	Mauritius	Korea	Argentina	Gabon
Korea	Colombia	Mauritius		Colombia	South Africa		Brazil	
Malaysia	El Salvador	South Africa		Costa Rica			Chile	
Thailand	Uruguay	Tunisia		Panama			Mexico	
				Peru			Trinidad and Tobago	
				Venezuela			Uruguay	

Sources: World Bank; Moody's Investors Service and Standard & Poor's; compiled by the Meltzer Report

Following recommendations based on these incorrect assumptions would have potentially very negative consequences on the development prospects of the countries in which the majority of the world poorest people live. Indeed, as Summers (2000) rightly points out, "one third of the people in Latin America live on less than $2 a day – and more people live on that income in China and India than the entire population of sub-Saharan Africa". The Meltzer recommendations also imply that poor countries which obtain access to private capital markets have their access to multilateral lending closed, which is a highly perverse incentive.

Doubtlessly, private capital flows can and should play not only an important, but hopefully a growing, role in financing developing countries. However, 1) there are clear and important market gaps in private lending and investing in developing countries, which can only be filled by multilateral bank lending and 2) there are also important circumstances where such multilateral lending can help catalyse additional developmentally valuable private flows, which would otherwise not take place. It is noteworthy that many private bankers and private institutional investors are themselves very aware of such limitations and welcome multilateral bank lending both to fill market gaps and to help catalyse new private flows[1].

2) **Market Gaps**

As regards market gaps, the following seem the most important:

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[1] Interview material.

a) Private lenders and investors tend to be unwilling to provide long-term financing, especially to developing countries;

b) Private flows are often volatile and reversible, as shown in recent currency and financial crises;

c) Private lenders and investors are less willing to channel resources to activities that are higher risk, but developmentally essential (such as lending to the financial sector especially but not only in times of, or just after, crises) or to activities where the social returns may especially in the short- to medium-term be higher than the private returns (such as health and education). Multilateral lending has, for example, been very valuable in providing both significant lending and technical assistance for the improvement and development of the financial sector to countries immediately after crises (e.g. South Korea in 1998; Mexico and Argentina, 1995). The private lenders would have considered lending to the financial sector in such circumstances as excessively risky.
Equally valuable has been post-crises multilateral lending to help fund social safety nets, in middle-income countries, crucial both to alleviate poverty and human suffering and to help provide political stability, essential for helping economic recovery. Again, the private lenders would not consider lending for social safety nets attractive, as social benefits would clearly outweigh private benefits.

d) Private lenders and investors tend to be less willing to channel resources to smaller economies, given that entering economies has fairly high transaction costs for them. This is one factor, which would seem to explain why the share of multilateral to total external debt tends to be far higher in smaller than in larger countries (see Table 2).

Table 2: Select External Debt Ratios to Multilateral Lenders
(% Multilateral/Total External Debt (end 1997)

Country	
El Salvador	68
Bolivia	59
Paraguay	58
Costa Rica	45
Trinidad and Tobago	37
Dominican Republic	28
Indonesia	16
Panama	14
Mexico	15
Argentina	10
Korea	9
Brazil	6

As regards to the first point (a), – unwillingness to lend for long maturities – we will illustrate it with reference to market gaps or failures inherent in private investment in infrastructure (this draws on fairly detailed research and interview material reported in Griffith-Jones, 1993).

i) Big infrastructure projects often take a long time to build up revenues and become profitable; these time periods are often far longer than those for which the international capital or insurance markets wish to lend for or insure against. Financial markets do not wish to commit themselves over very long periods, as they seem to perceive that risk increases over time. Furthermore, in infrastructure, the initial phase (of preparation and construction) is seen as particularly risky; this phase often requires very large amounts of investment, which private lenders or investors are not keen to fund, especially without official guarantee or co-financing.

ii) Even in certain developed economies (e.g. Greece or Portugal), but far more so in middle-income countries, domestic capital and financial markets are relatively under-developed, especially for long-term maturities, and country risk is seen as relatively higher than elsewhere, which means that shorter maturities are available. As domestic capital markets deepen and develop, this problem should be gradually overcome.

3) Private lenders or investors will not benefit from externalities to projects, such as increases to welfare provided by positive environmental implications of certain projects or by additional external positive economic effects captured by other private economic agents, that are not reflected directly in income to the infrastructure project.

As regards to the second point (b), private lending to middle-income countries tends to have an average significantly shorter maturities than does official lending, mainly corresponding to multilateral bank lending. (see Table 3)

Table 3: Average Maturity (in years) of New Commitments for Middle-Income Countries

	1970	**1980**	**1990**	**1995**	**1998**
Official creditors	24.5	20.1	19.7	16.7	15.0
Private creditors	9.6	9.8	13.8	7.4	8.9

Source: World Bank. Global Development Finance Report. 2000

Furthermore, a very large proportion of bank lending to developing countries is very short-term – less than one year. According to BIS data, in mid-1999, the proportion of short-term lending to total lending for all developing countries was 49.6 per cent, proportion that had been even higher in the previous years. Also, statistics of average maturities for private lending tend to overestimate the length of such loans, as they do not take account of mechanisms such as put options, which allow creditors – in crisis conditions – to shorten the term of loans or bonds, by exercising the put option; for example, a seven year loan – statistically recorded as such – can have a one year put (or a put linked to a decline in creditworthiness) which allows the creditor to ask for early repayment. Put options have become an important additional source of vulnerability, as private lending can be more short-term than expected, especially in times of crises.

As a result, any large shift from official to private sector borrowing would significantly decrease the average maturity of the debt of these countries, which would increase substantially the risk of volatility and reversibility of such flows; such volatility and reversibility is widely recognised as one of the main (if not the main) factor causing recent very developmentally costly financial and currency crises. These crises have occurred not only in countries with underlying weaknesses in their economic policies and/or in their financial sectors, but also in countries where these domestic elements are fairly positive, but their capital market access is hurt by contagion or by other external shocks, such as deterioration of their terms of trade.

Not only is multilateral lending more long-term, it also tends to be counter-cyclical. There is indeed clear evidence, for example, during the debt crises of the 1980's in Latin America, that World Bank lending increased quite significantly as private flows fell sharply, thus helping attenuate the contractionary effects on the economy of the large falls in private lending. (see Table 4, in Griffith-Jones and Ocampo, 1999)

3) The Catalytic Role of Multilateral Lending

Not only does multilateral lending step in to fill important market gaps, also, of clear importance, is its catalytic role in encouraging additional private flows, especially to countries (e.g. after crises), or sectors, (e.g. infrastructure), with limited access to private finance. Varied mechanisms can be used for achieving this purpose, including co-financing and guarantees, as well as new mechanisms such as extending preferred creditors transactions (for the latter, see Standard and Poor's Credit Week, June 1990). Guarantee mechanisms need to be carefully designed, so that they only cover those risks which the markets themselves are unwilling on their own to cover, this will lead to additionally of flows. Both multilateral lending and guarantees should only be given when projects have been carefully evaluated, and they are economically viable.

Not only the World Bank and the regional development banks – but also particularly the IFC, MIGA and their equivalents in the regional banks – seem to clearly play on important catalytic roles in attracting additional private flows to emerging markets. Through different mechanisms, they help attract private flows to countries, sectors and individual private borrowers that would probably otherwise not receive them, they help widen the range of private investors and lenders, to include, for example institutional investors such as pension funds and they help achieve longer maturities (either by the general comfort they provide or by specific mechanisms, such as guaranteeing or lending for the later maturities within a specific loan). Private lenders and investors clearly appreciate and value this catalytic role[2].

Naturally the modalities used by the multilaterals to help catalyse private flows need to be reviewed and evaluated carefully, so that relevant modifications improvements and updating can be introduced to maximise their development impact and minimise any problematic effects. However, this is very different from the Meltzer proposals, that include abolishing the IFC, MIGA and eventually eliminating the World Bank's lending and catalytic role, both to middle-income countries and to poor countries with market access.

4. Conclusions

It can be concluded that the private sector would not increase its exposure to developing countries if the World Bank and the IMF reduced its role as dramatically as the Meltzer Report suggests. In fact, the perception of risk by the private lenders and investors would increase significantly, as they find comfort in the World Bank's role in co-financing, in its counter-cyclical lending in times of crisis, and they value the catalytic role of the World Bank itself, as well as the IFC and MIGA[3]. As regards the changes proposed for the IMF, they are even more problematic from this perspective, particularly for those countries that were unable to pre-qualify. These latter countries would have their access to private markets severely restricted; furthermore, these countries would probably be less willing to borrow, as they would not have any access to official emergency financing. This would be both inefficient – as private capital flows can bring important benefits to developing countries – and paradoxically very market-unfriendly, as it would clearly discourage private lending and borrowing, as well as opening of the capital account by developing countries.

Furthermore, the reduction of multilateral lending would tend to deprive developing countries of external flows essential to development such as more long-term flows to fund infrastructure profitable only in the long-term, investment with higher social than private returns (in areas such as primary education and primary health care) and lending to improve and support financial sectors, especially, but not only, during and after crises; as has been learned again and again, financial sector crises (especially if interacting with Balance of Payments crises) tend to have very disruptive effects on development. Last but certainly not least, the reduction of multilateral lending and the more limited role for the IMF would significantly shorten the average maturity of capital flows – both because multilateral lending is significantly longer than private flows and because the maturities of private flows would tend to shorten, as private lenders and investors saw their perceived risk increase, due to the higher risk of financial and currency crises. Such private lenders fears would risk becoming self-fulfilling, as recipient countries would become more vulnerable to currency crises, due to shorter maturities.

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[2] Interview material.

[3] Interview material.

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