

THE QUEST TO JUSTIFY A LONG LASTING ROLE FOR MULTILATERAL DEVELOPMENT BANKS

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Abstract

In this paper we examine whether the poor performance of multilateral development banks (MDBs) in catalysing resources for development, together with the increased capability of international markets to care for developing countries' needs and risk, have made MDBs redundant. We conclude that market failures are no longer enough to justify a role for MDBs, but we suggest that their existence can still be warranted if such institutions are re-orientated towards the relief of an under-investment bias in less developed economies.

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1. Introduction

For the past sixty years, statistics on international lending report on a group of financial institutions designated either as multilateral development banks (MDBs) or as international financial institutions (IFIs). Yet, such institutions did not exist before World War II. Back then, the banking structure was simpler - privately owned banks financed at the same time governments and corporate. Today, three different groups of lenders - banks, governments and MDBs finance both groups of borrowers.

The role of MDBs has been controversial ever since its conception. Many of the questions are raised over and over again without the discussants realising the redundancy. Such examples can be found, for instance, in the choice of the sectors or the policies that they should favour, namely infrastructure or social policies.

Nowadays, all kinds of people scrutinise the work of MDBs and often not for the best of reasons, as was well illustrated by the recent controversy over Mr. Wolfowitz's nomination as head of the World Bank. Many are politically minded, some are just trying to secure sponsorships for consultancies and NGOs, but others are the result of special task forces set up to discuss the role of MDBs. Some of the proposals made by the later group of initiatives were recently summarised in a G24 Discussion Paper (G24, 2003) and we shall not elaborate on them here.

Instead, we will simply take for granted that the extraordinary growth of international capital markets experienced recently would inevitably question the future of the MDBs. So, now more than ever, these institutions need to justify their track record and their future role. It is no longer a matter of “filling in the gap” of urgent capital necessities, which was easily accepted in the past.

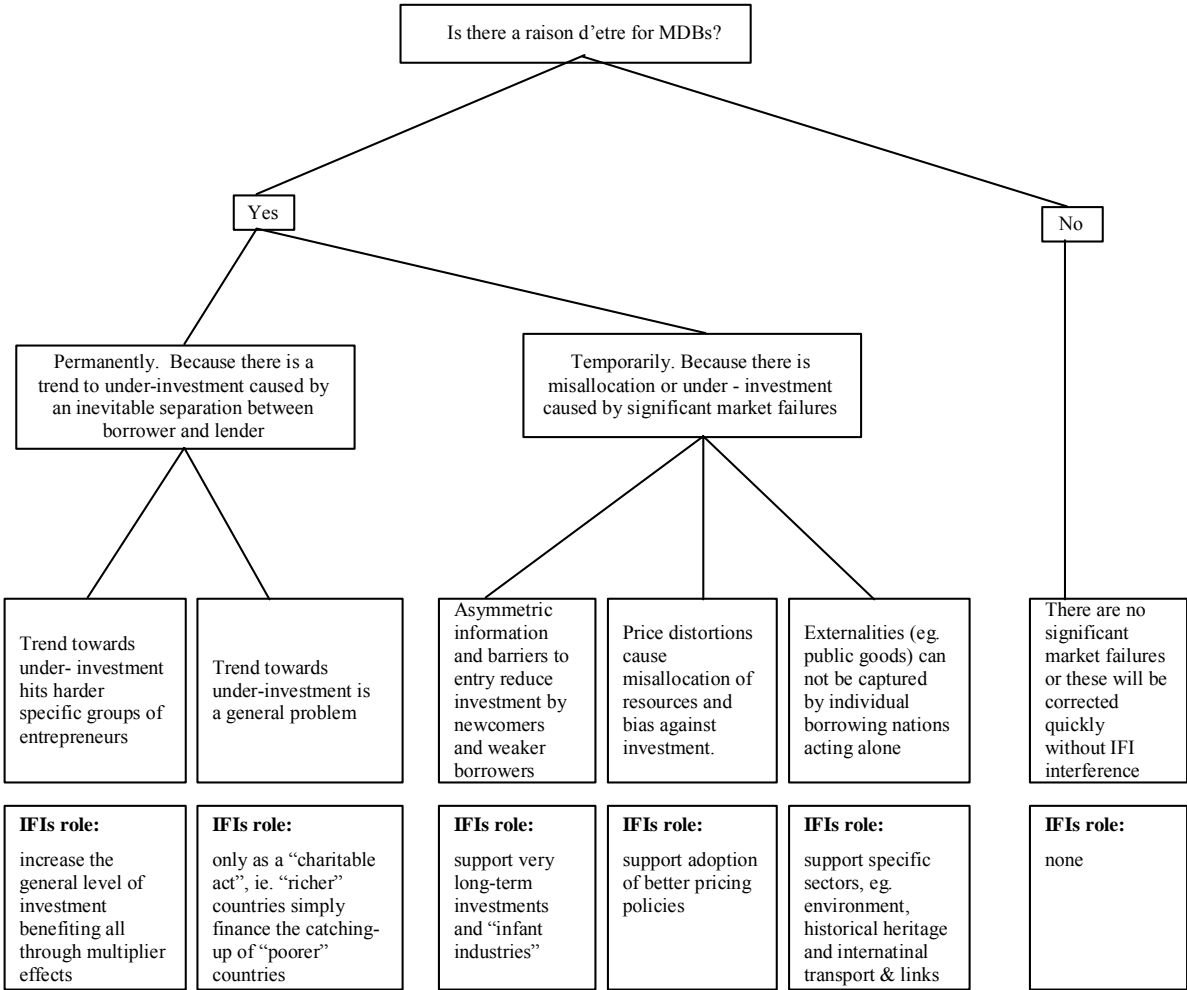
We begin with an examination of the three possible roles of MDBs, followed by a discussion of the reasons why their financial intermediation has been so limited and conclude by advocating a “raison d’être” based on the relief of the under-investment bias in credit economies.

2. The rationale for and against multilateral development banks

MDBs need to justify their role. This sets them apart from private market operators, which do not need to worry about such "existentialist" issues. For them, the justification is automatically obtained by surviving and prospering in the market.

The full range of options available to define a role for the MDBs is easier to visualise through a diagram, as the one showed below:

Figure 6. The possible roles for the MDBs



Should we try to give a monosyllabic reply to a question on whether MDBs justify their existence, the “no” would seem the most appropriate answer. In other words, if the real world were close enough to the description given by the classical or neo-classical models of the economy, there would be no role for institutions like the ones we analyse.

The rationale for this assertion is the following: given the perfect substitutability of production factors, individual investors would never be constrained by funding requirements. That is, the existing savings would always chase the most attractive project in terms of return. Financial intermediaries, competing among themselves to maximise their profits, would ensure efficiency in channelling existing savings to those investments with the highest returns.

Therefore, non-profit driven institutions would be poor competitors. They could only bring distortions into this otherwise perfect functioning of the market.

However, this popular but very simplistic point of view is delusive, both in theory and practice. The empirical data provided by the past led to the following conclusion: even well-functioning market economies are faced with many situations of market failures and with situations where externalities can be substantial. The “flaws” of the market most frequently quoted are: the existence of public goods, price distortions and the asymmetric levels of information among economic agents. Each market failure precludes the functioning of a truly competitive market system.

So, a temporary role for MDBs has been advocated as a more reasonable approach until developing countries would have been able to cope with such market failures on their own. This temporary role should come to an end after a while, either because one concludes that market failures have been eased or because MDBs failed to deliver on their expected role. We do not discuss here which the outcome was, but present instead an overview of the role played by MDBs in international financing.

3. Why is the role of MDBs in financial intermediation so limited?

Overall in the last 35 years net financing flows have hovered between 100 and 350 billion dollars despite the global economic growth experienced in the last three decades. Figures 1 and 2 show that developing countries have been having problems in penetrating the booming markets of the 1990s³; but such difficulties are different from those experienced in the

³ Recent studies concluded that “the catalytic effect is nuanced and complex but that overall it is weak.” See Bird and Rowlands (2001, pp.)

previous two decades. Then they attracted only about 45% of private funding while nowadays the private sector accounts for more than 70% of their net financing.

Figure 1. Total net financing flows 1970-1996

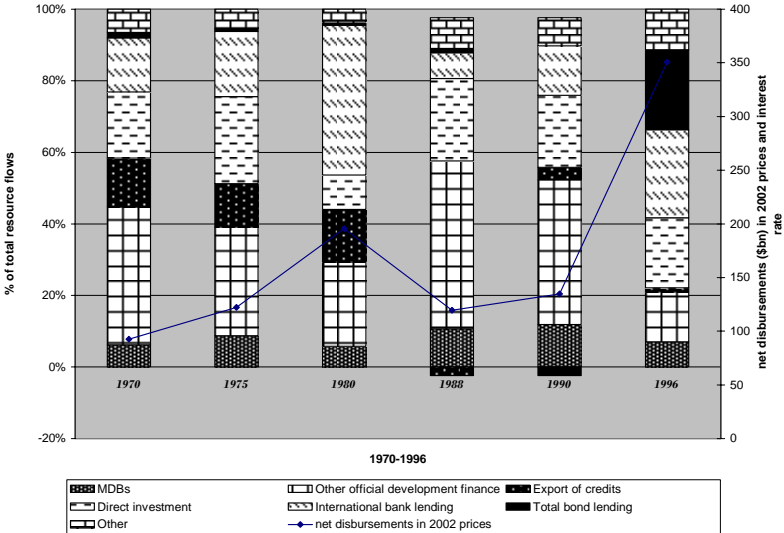
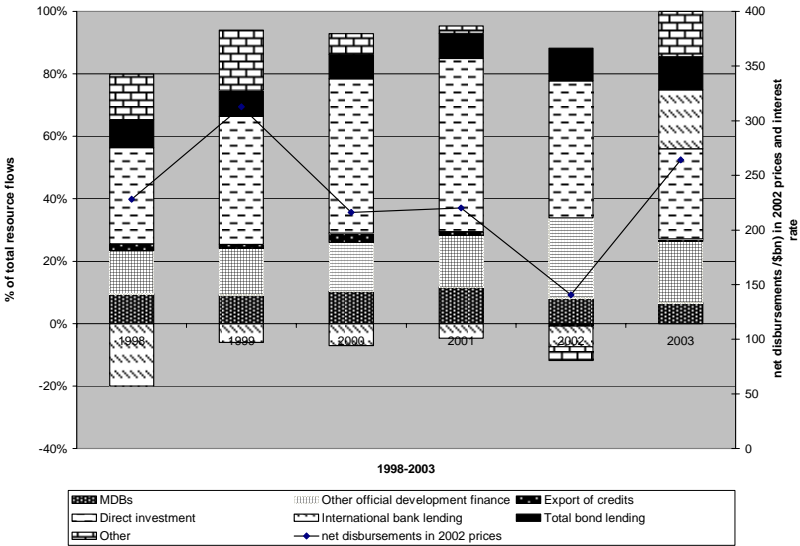


Figure 2. Total net financing flows 1998-2003

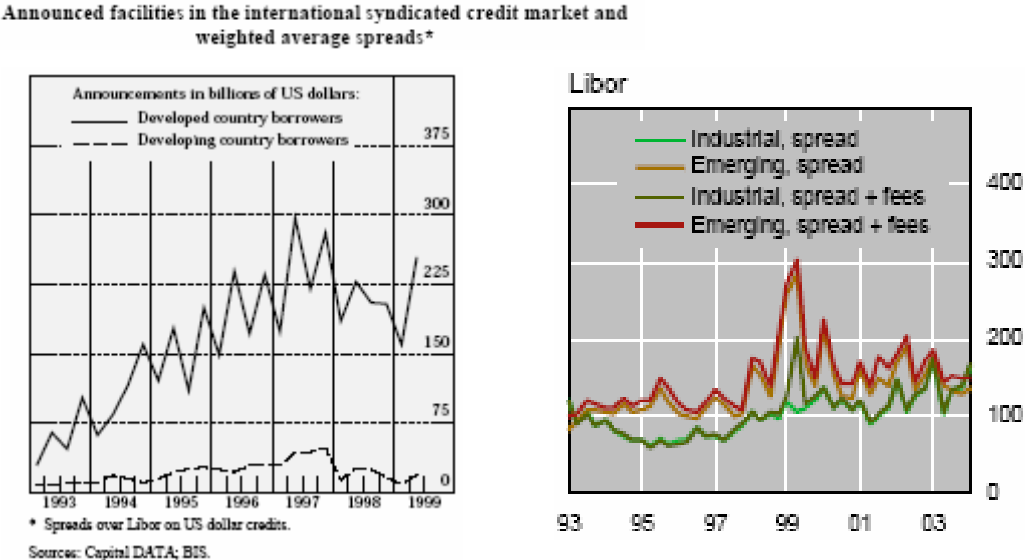


Another interesting fact that these charts highlight is that the total net lending of the MDBs in the period 1970-1996 averaged almost 83 billion dollars, while the international bank lending was close to 232 billions. Nevertheless, in the next period, 1998-2003, their lending increased to 156 billion dollars, as the international bank net lending suffered an enormous contraction -

88 billion dollars. The conclusion that can be drawn from this is that the MDBs acted as lenders of last resort rather than development institutions.

An assessment of the contribution of MDBs for the total amount of debt financing shows that in the aftermath of the Asian crisis of 1998 their share has passed, as mentioned before, from around 21% to 71%. Still, although the Asian crisis has caused an impressive curtailment of net flows in international bank lending, in our opinion this does not mean the key debt market for developing countries – the syndicated market – was closed to them.

Figure 3. Syndicated loans and spreads



As it can be seen in the figure above, in the 1990s, the syndicated debt market experienced a five-fold increase. This continued the impressive growth experienced in previous decades and it was not only in terms of value but also in terms of size of the transactions. For instance, in 1968 the largest ever syndicated loan, organised for the U.K. conglomerate ICI, was only for an amount of USD 250 million, that is, about 980 million dollars in 2002 prices. This year, the largest loan (raised by E.ON AG) was for 7.3 billion euros, while corporates from

developing countries were able to raise more than 650 million dollars (e.g. Maxis of Malaysia).

Yet remarkably, the overall share of borrowers from developing (non-OECD) countries remained rather small. Still, we sustain that this growth of the international markets, of which we may mention also the international equity markets, the junk bonds and Eurobonds market, is jeopardising MDBs survival and makes it harder for them to compete and to justify themselves through the correction of market failures.

Before considering why MDBs did not offset completely the limits and the contraction in commercial lending (political willingness, risk taking capabilities or insufficient demand for their financing) we must assess first if that was out of lack of resources. This is tantamount to answering the following question⁴: were the MDBs self-imposed gearing ratios too tight?

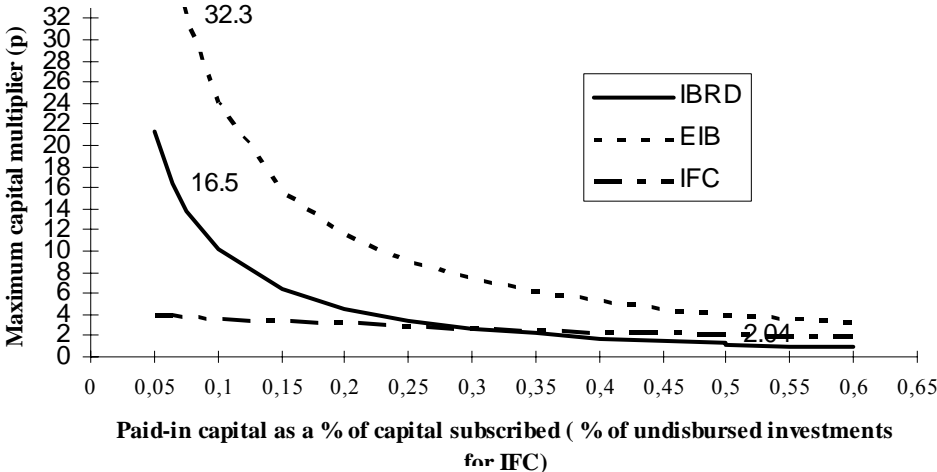
The international financial institutions use three main definitions of gearing. The AsDB, AfDB and IDB established that the amount of outstanding loans, guarantees and equity investment plus undisbursed commitments shall not exceed the amount of capital subscribed plus accumulated earnings and reserves. The IBRD and the EBRD define a similar ratio, but exclude the undisbursed commitments from the numerator. The EIB uses a much simpler and more generous ratio according to which the outstanding loans and guarantees can not exceed 2.5 times the amount of subscribed capital. Finally, the IFC, instead of adopting any formal asset gearing ratio, uses a debt leverage limit that is equivalent to a very tight gearing ratio, as

⁴ This means assessing the amount of funding intermediated with a given capital base, which we will call for convenience capital multiplier. Indeed, as MDBs adopt either implicitly or explicitly an asset gearing ratio, the maximum multiplier of paid-in-capital (ρ) can be defined as follows:

$$\rho = \frac{(\text{Loans} + \text{Equity investments})}{\text{Capital}} - 1.$$

it can be seen below, in figure 4. The chart depicts the trade offs for three MDBs (EIB, IBRD and IFC) and it shows how the maximum capital multiplier would vary should MDBs increase the amount of subscribed capital without actually increasing the amount of paid-in capital.

Figure 4. Maximum potential capital multiplier of selected MDBs



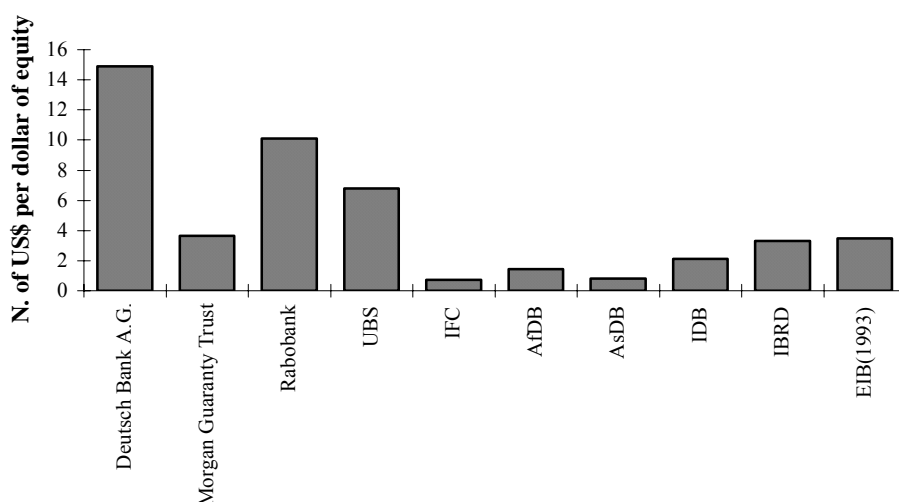
Notes: Values plotted correspond to maximum values in 1993.

By comparing the capital multiplier of MDBs to other triple A rated commercial banks, as shown in figure 5 below, it is clearly confirmed that neither the EIB nor the IBRD were constrained in their capital multiplier by a self-restricting gearing ratio, since the actual values were respectively only 11% and 20% of the maximum value possible outlined in the chart 4 above.

The case of the IFC is slightly different.⁵ As this institution has a self-imposed maximum multiplier that is extremely low (slightly over US\$ 2 per dollar of paid-in capital), it has achieved a level equal to 35% of its maximum, a value that can still be considered quite low.

⁵ In the case of IFC the maximum paid-in capital multiplier is derived from the leverage ratio as follows: IFC defines its leverage ratio as $\frac{D}{R + K} = 2.5$ and from the balance sheet identity we have $L = 3.5(R + K) - C$ so that, with a reserve

Figure 5. Comparing the capital multipliers of AAA-Rated banks and MDBs (in 1992)



Finally, it is also interesting to note how MDBs would perform if, like the commercial banks, they were under obligation to meet BIS capital adequacy levels. Information is only available on IFC, which estimated that according to the BIS rules, their 1992 capital adequacy ratio was of 49%. This was a very high value even under the cautious rules it had to obey⁶. Not surprisingly, as mentioned in a 1993 review of IFC financial policies, the corporation began to liberate itself from such regulatory constraints but in 2003 the corporation was still capitalised at a level of 45%.

MDBs' additionality is always questionable in booming financial markets. However, the most spectacular growth ever to be registered was in the secondary markets. A single but revealing image is given by the value of the transactions cleared at just one of the two clearing systems: Euroclear. The 2001 value indicates an activity of 209,9 trillion euros. This number doesn't

requirement of $R = 0.1L$ and a liquidity requirement of $C = \beta L$, we obtain $L = \frac{3.5K}{(0.65 + \beta)}$ and the multiplier of paid-in

capital is $\rho = \frac{L}{K} - 1 = \frac{3.5}{(0.65 + \beta)} - 1$, where in terms of notation D represents total debt, K paid-in-capital and accumulated earnings, L outstanding loans and equity investments and β the ratio between undisbursed and disbursed loans and equity investments (the value of β in 1992 was 0.5).

⁶ Even considering that IFC is very active in equity financing.

tell us much, unless compared to the figure for 2004 when it reached the fabulous level of 307.1 trillion euros. The relative growth of this market is even more extraordinary if we take into account the fact that back in 1992 it was only 125 billion euros.

However, episodes of financial euphoria need to be taken in an historical perspective. The economist Krugman (Krugman, 2001) provides an interesting comparison of this century's investment with that from the last 100 years. The 19th century trade was accompanied by massive national capital movements, which were much larger, relative to the size of the world economy, than anything seen since WWI: in a typical year in the late nineteenth century, Britain invested about 40 per cent of its savings overseas.

Similarly, in *The Economic Consequences of Peace*, (Keynes, 1919) Keynes describes the pre-war leading role of Germany by drawing attention to its high level of foreign investment, estimated to total £1.25 billion (almost USD 50 billion in 2002 current prices) half of which invested in Russia, Austria, Hungary, Bulgaria, Romania and Turkey. Moreover, "through the system of 'peaceful penetration', Germany gave these countries not only capital, but, what they needed hardly less, organization".

The average annual value of gross direct foreign investment by Germany and Japan - the surplus economies in the 19980s - was USD 11 billion and USD 71 billion during the second half of the 1980s, that is, less than 5 per cent and less than 11 per cent of their domestic savings respectively.

And of course the 19th century was an era of mostly open borders marked by international migration that dwarfs anything recent. It is a common remark among economic historians that

Germany, Japan or the US economies are not now, and may never be, as integrated with and as dependent on the global economy as Britain has been since the reign of Queen Victoria.

The overall impression gathered from this brief survey conducted to evaluate the amount of financing going to developing economies is that responding to these countries' medium and long term credit necessities is far from an "infant industry". According to Sir William Ryrie, who led the IFC between 1984 and 1993, the progress of the East Asian, Latin and ex-communist states has little to do with the pressure from IMF or the World Bank, which "is often exaggerated ...The market economy, combined with sound macro-economic policies, is now widely recognised as offering developing countries the best prospect of rapid growth and rising standards of living for the population at large. And the same countries that are following these policies are attracting an inflow of private capital on a scale which has not been seen before."

However, through a closer look, it can be demonstrated that the writing-off of MDBs as useless institutions would be a precipitated thing to do. So we move to the third possible role of MDBs - the offsetting of under-investment bias.

4. Under-investment

The third "raison d'être" that might give MDBs a permanent role is based on the idea that an under-investment bias is an essential feature of modern credit-based economies. In order to elucidate the concept, we shall highlight the built-in vicious circle that exists in credit based economies.

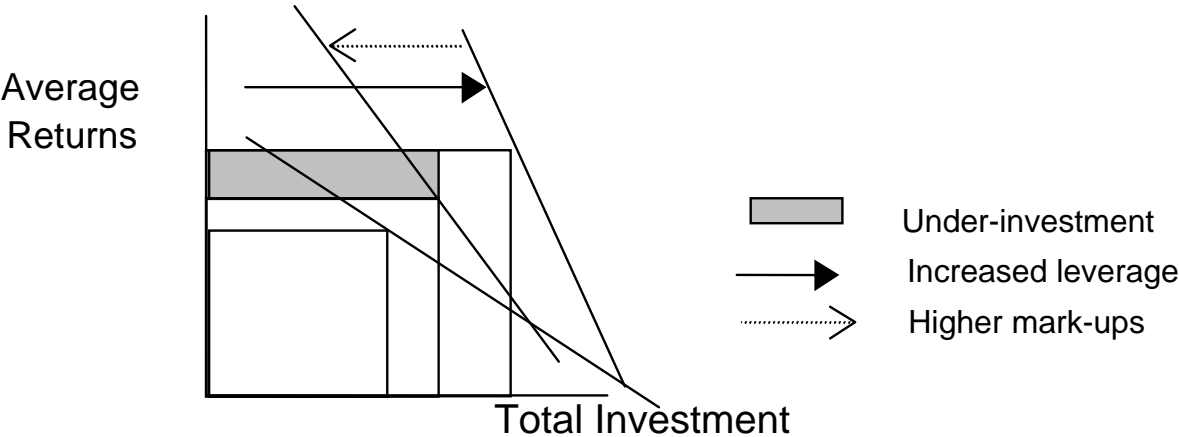
The basic idea stems from a point made by Keynes in his *General Theory* (Keynes: 1936, pp.144) that the separation between borrower's and lender's risks in part involves a duplication of the entrepreneurs' risk. The first is a true social cost, but "the second, however, is a pure addition to the cost of investment which would not exist if the borrower and lender were the same person". If the venture is a risky one, e.g. its realisation is more uncertain simply because it is a long term venture, then, the borrower and the lender will both require a wider margin. However, the hope of a very favourable outcome that may balance the risk in the mind of the borrower is not likely to cheer the lender.

What happens is that prudent bankers often decline to lend not because the borrower's collateral offered as security is insufficient but because they have to rely on the borrowers past track record. Experience tells them that "failure breeds failure" while "success breeds success". Thus, their natural bias towards lending to the rich rather than the poor is in fact the result of searching for good performances. Accumulated wealth works as a screening device to identify successful entrepreneurs.

This results in a built-in vicious circle that no individual banker can break on its own. To move the reasoning further, let us show how this vicious cycle fits into the question of deciding whether there is a permanent role of the MDBs or not. Whenever resorting to debt-financing investments, entrepreneurs will drop marginal investment opportunities. Those opportunities that do not earn enough to pay for the borrowed funds while still giving the entrepreneur his minimum return will not be carried on.

Therefore, the level of investment decided by entrepreneurs will be always below the amount they would invest if they were simultaneously the lender and borrower (i.e. without leverage). We mean by an investment shortfall, or under-investment bias, the amount of potential investment not carried out due to the use of credit to finance investment. This can be better explained by analysing diagram 6 below. The drawing shows that the higher the leverage, the higher is the level of investment but also the larger is the under-investment bias.

Figure 6. An illustration of the effects on returns and investment



The relative impact of leverage on increased investment and under-investment is largely a function of the mark-ups charged by lenders, the risk of the project and the entrepreneurs' appetite for risk. In our opinion the under-investment bias is a feature, not a failure of the system. It is something that is intrinsic to the debt financing of investments. Nevertheless, we need to demonstrate that the under-investment is significant and we need to find ways to overcome it. Therefore, it seems advisable to use a level of aggregation at the sector level and take into account each country's specificities that influence the possibility of MDBs being additional rather than substitute. However, concentration on sectors alone is not an entirely

reliable solution and some consideration has to be given also to country specific issues, but this is not the purpose of the present work.

5. Conclusion

At the age of sixty, persons are mature and there is no reason why the institutions or the industries they should supposedly promote would not have reached the same maturity. Therefore, we need to raise the question of whether MDBs will reach “retirement age” soon or not. In other words, are MDBs growth years over? Partly, the answer to this question is on the recent surge of international financing activity.

However, we cautioned about the dangers of considering this process as a new situation without precedent in history. Indeed we may be experiencing just an era of speculative international capital movements, similar to the late 19th century boom of leveraged transactions and securitisation that, necessarily, will come to an end. Nevertheless, whenever the day of reckoning comes, there is no doubt that MDBs’ operations and prospects will bear the effects of current trends.

To conclude with, a final verdict on a lasting role for MDBs needs to look beyond direct measures of lending and leverage and to consider the impact that lending will have on the amount and quality of investment that is being sponsored through MDB lending. The difficulty here resides in the attribution of any increase in investment to a specific source of funding. It can also be questioned whether funding has anything to do with investment decisions. Yet an approach measuring the impact of MDBs on investment is not only relevant but it is also more directly related to the development objectives that stay at the origin of most MDBs.

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