Multilateral financial institutions: overhauling development finance

Yilmaz Akyüz [1]

Need for more development finance

There is a consensus on the need to drastically increase external financing for developing countries in order to achieve acceptable growth and make a dent in poverty. According to an UNCTAD[2] estimate for sub-Saharan Africa, this requires doubling the level of development finance. This estimate was confirmed subsequently by the Zedillo Commission[3] for developing countries as a whole. On various estimates meeting 2015 MDGs would require an additional amount ranging between USD 50 billion and USD 150 billion.

Where is this to come from? Private flows, multilateral lending or bilateral loans and grants? Of these, private flows are not a reliable source of finance for most developing countries. Multilateral financial institutions are increasingly marginalized as a source of development finance. Bilateral aid does not only fall short of what is required, but also its availability and allocation are driven by political considerations and its quality is dubious. There is therefore a need for a fundamental rethinking. A genuine reform should not only be about new sources of development finance, but also for different mechanisms and modalities for their allocation. In particular aid should cease to be the central element of multilateral financing and the multilateral financial institutions need to be reformed drastically both in respect of their mandates and resources.

Private capital flows: unstable and unreliable

The postwar era has seen two boom-bust cycles in private capital flows to developing countries: the first beginning in the early 1970s and ending with the debt crisis in the 1980s, and the second beginning in the early 1990s and ending with a series of crises in Latin America, East Asia and elsewhere. The first boom was driven by the rapid expansion of international liquidity associated with oil surpluses and growing United States external deficits, and facilitated by financial deregulation in industrialized countries and rapid growth of Eurodollar markets. Excess liquidity was recycled in the form of syndicated bank credits, encouraged by the Bretton Woods Institutions fearing a collapse of global demand. However, with increased debt servicing difficulties brought about by the hike in United States interest rates and global recession, there was a sharp cutback in bank lending, forcing debtor countries to generate trade surpluses to service debt through cuts in imports and growth. The result was a debt crisis and a lost decade for many developing countries in Latin America and Africa.

The second boom came after almost ten years of suspension in private lending to developing countries. It was encouraged by the success of the Brady Plan for sovereign debt restructuring, liberalization, privatization and stabilization in developing countries, and rapid expansion of liquidity and cuts in interest rates in the United States and Japan in conditions of economic slowdown. Unlike the first boom, a large proportion of private inflows were in equity and portfolio investment, rather than international lending. In most cases these were driven by prospects of quick capital gains and short-term arbitrage opportunities. When they were reversed, many debtor countries were again faced with negative net transfers, and sharp declines in income and employment.

A third cycle started at the turn of the millennium with a swift recovery in private flows, driven by a combination of extremely favourable conditions including historically low interest rates, high levels of liquidity, strong commodity prices and buoyant international trade. Capital inflows in the current cycle have exceeded the peak observed in the previous boom of the 1990s, and most developing countries have shared in this recovery. However, the result is again increased financial fragility, as asset prices and exchange rates in many countries have been pushed beyond levels justified by economic fundamentals. Events in recent weeks suggest that with the combination of rising oil prices and interest rates, persistent and growing global trade imbalances, and increased volatility of the dollar this boom is now nearing its end. A number of emerging markets have started experiencing sharp declines in their stock markets and currencies. Once again countries dependent on external capital flows for balance of payments financing face the risk of tightened external financial conditions and collapse of growth.

Foreign direct investment (FDI) is often promoted as a more reliable source of development finance. Much of it in developing countries has been in the acquisition of existing assets rather than new (greenfield) investment to expand production capacity. Greenfield investment tends to lag rather than lead growth, often going to countries that do not have significant external financing gaps. Despite the rhetoric of the Bretton Woods Institutions that the recent upturn in FDI to poor countries reflects improving performance and better investment climate and growth prospects, evidence examined in a recent UNCTAD Report on Africa[4] shows that a chunk of this has been going for the exploitation of rich minerals and oil reserves in a handful of post-conflict countries or to countries with newly discovered oil and mineral resources.

Multilateral lending: burden or relief?

Multilateral financial institutions are increasingly becoming a burden, rather than a relief, for developing countries. In every year since 1991, net transfers (that is disbursements minus repayments minus interest payments) to developing countries from the International Bank for Reconstruction and Development (IBRD) have been negative. Since 2002 net disbursements have also become negative. In effect, taken as a whole, the IBRD is not making any contribution to development finance other than providing finance to service its outstanding claims. Much is the same for regional development banks. The problem here is that, for reasons related to conditionality and bureaucracy, countries which are eligible for IBRD loans are generally unwilling to borrow as long as they have access to private markets, even when this means paying higher rates. On the other hand, many poorer countries which need external financing are not eligible for IBRD loans.

The International Development Association (IDA) is the only source of net finance for developing countries from the World Bank. However, quite apart from the problems associated with the dependence of the Bank on a handful of donors for development financing, IDA disbursements are small, in the order of USD 4-5 billion a year, for

1 Former Director, Division on Globalization and Development Strategies, UNCTAD. Based on a presentation made in conference “New Financing Mechanisms for Africa’s Development”, IPALMO, Turin. 7 December 2005.

2 United Nations Conference on Trade and Development.

3 United Nations (2001). “Technical Report of the High-Level Panel on Financing for Development. Recommendations of the High-level Panel on Financing for Development”. Available from: <www.un.org/reports/financing/report_full.htm>.

4 UNCTAD (2005). *Economic Development in Africa. Rethinking the Role of Foreign Direct Investment.* Geneva, United Nations. Available from: <www.unctad.org/en/docs/gdsafrica20051_en.pdf>.

the entire IDA-eligible countries. Putting IDA and IBRD together, the contribution of the World Bank to the external financing of developing countries is negative by some USD 1.2 billion. Net flows to sub-Saharan Africa are also negative from IBRD. From the Bank as a whole they are positive but less than USD 2 billion, about 10% of what is needed. For a sample of poorest developing countries, financing provided by the World Bank is in the order of USD 3 billion compared to private grants of some USD 10 billion.[5]

Regarding the Fund, lending from Poverty Reduction and Growth Facility (PRGF) is a very small proportion of financing made available to developing countries. In the past several years the Fund support has focused on financial rescue operations in emerging markets, bailing out international creditors and lenders to crisis-stricken countries. At the end of 2004 outstanding PRGF credits were less than SDR 7,000 billion (USD 9,900 billion) or 10% of total outstanding IMF credits. In 2005 total PRGF lending approved was less than USD 500 million.

The IMF is also being marginalized in the provision of finance and liquidity to developing countries. All major emerging market economies, except Turkey, have now paid in and exited from IMF supervision, leaving only the poorest countries as its only regular clientele – barely a strong rationale for an institution established to secure international economic stability. This situation also poses the question of the IMF's financial viability. Poverty lending does not generate enough income to pay the staff and run the institution, and the IMF relies primarily on crisis-lending to emerging markets to generate some USD 800 million per annum to meet its administrative expenses. Ironically, financial viability of the IMF has come to depend on financial instability and crises in emerging markets.

Donor aid: problem or solution?

Donor aid made available either directly or through the multilateral financial institutions as concessional loans and grants is the only major source of official finance for development. Here the problem is not just about its adequacy. There is also a bigger political problem. Aid is primarily a post-colonial, cold-war instrument, and its availability and allocation are governed by political considerations rather than expediency, generally serving the interests of donors rather than recipients. As noted, a very large proportion of development financing provided by the Bretton Woods Institutions relies on aid rather than regular resources of these institutions. In contrast with the trading system where bilateralism is widely seen as a potential threat to the multilateral system, in finance it is taken for granted that bilateral and multilateral arrangements are complements. This approach also dominates debt initiatives such as the Heavily Indebted Poor Countries Initiative (HIPC) which combines multilateral debt with bilateral debt owed to donors in the Paris Club, enhancing the room for political influence.

The dependence of the Bretton Woods Institutions on the discretion of a small number of donors is a main source of shortcomings in their governance structures. The practice of combining IMF money with contributions from major countries in financial bailout operations in emerging markets has enhanced the room for political leverage in IMF lending decisions by its major shareholders. The establishment of IDA has played an important role in reducing the autonomy of the World Bank secretariat, increasing its dependence on donors and subverting its governance by enhancing the scope for political leverage. This dependence on donor contribution would be enhanced if IDA remains in the World Bank while an increased proportion of it is made available as grants – a step that needs to be taken since many of the IDA countries are already highly indebted and in need of a substantial debt write-off.

Reforming the reformers

Thus the first step should be to separate bilateral and multilateral arrangements for development finance and debt. Certainly, it is up to sovereign nations to enter into bilateral agreements on debt and financing, but these should be kept outside the multilateral system. This means taking the donor-driven facilities out of the Bretton Woods Institutions; that is, IDA from the World Bank and PRGF from the IMF. The amounts involved are quite small, but the impact on the governance of these institutions could be important.

The European Union has recently announced plans to create a trust fund to disburse European aid to Africa without depending on the World Bank, arguing that European aid money should be spent according to European policies but the EU does not have the influence it should in the World Bank. This demonstrates once again the predominance of political considerations in the provision of aid. It is thus a welcome initiative in so far as it helps separate bilateral from multilateral lending, but it should also accompany steps to make the World Bank an independent multilateral development finance institution.

Any serious reform of the global arrangements for provision of finance to developing countries should also include mandate, operational modalities and governance of the Bretton Woods Institutions. There is no justification for the IMF to be involved in development and poverty alleviation. The Fund should focus on the provision of short-term liquidity to countries experiencing temporary payments shortages, including poorer countries which are particularly vulnerable to trade shocks. It should revive the Compensatory Financing Facility as a concessionary facility. There should be greater automaticity in access to the Fund, and limits should be determined on the basis of need. The Fund should stay away from structural conditionality and focus on macroeconomics. It should not be allowed to be engaged in financial bail-out operations but develop orderly debt workout mechanisms and focus on crisis prevention by helping manage unsustainable capital inflows to developing countries and through effective surveillance over policies in industrial countries.

An appropriate source of funding for the provision of international liquidity by the Fund is the Special Drawing Rights (SDRs). The case for creating SDRs to provide funds for current account financing is much stronger than the case for using them to back up financial bail-out operations associated with a potential lender-of-last-resort function advocated by the Fund after the Asian crisis. Current arrangements would need to be changed to allow the SDR to replace quotas and General Arrangements to Borrow (GAB) and New Arrangements to Borrow (NAB) as the source of funding for the IMF. The Fund should be allowed to issue SDR to itself up to a certain limit which should increase over time with growth in world trade. The SDR could become a universally accepted means of payments, held privately as well as by public institutions. Countries' access could be subject to predetermined limits which should also grow with world trade.

Several issues of detail would still need to be worked out, but once an agreement is reached to replace traditional sources of funding with the SDR, the IMF could in fact be translated into a technocratic institution of the kind advocated by Keynes during the Bretton Woods negotiations. Its funding would no longer be subjected to arduous and politically charged negotiations dominated by major industrial countries. Such a move would also be an

5 World Bank (2005). *Global Development Finance 2005: Mobilizing Finance and Managing Vulnerability.* Table 5.1, p. 90.

important prelude to a fundamental reform of the governance of the IMF, notably with respect to distribution of voting rights.

Many of the problems encountered in multilateral development finance and policy advice could also be addressed if the World Bank went back to its original operational modalities and concentrated on facilitating capital investment through project financing, rather than trying to fix all kinds of policy and institutional shortcomings in developing countries through structural adjustment and development policy loans. It should cease to be an aid institution and become a development bank, intermediating between international financial markets and developing countries. As originally envisaged, its financing should be provided in loans rather than grants, and made available only to countries which do not have access to private capital on reasonable terms.

While improving the functioning and governance of the Bretton Woods Institutions such arrangements would still leave the main problem unanswered: financing global public goods including concessional loans and grants to the poorest countries. Here the issue is twofold; institutional arrangements and resources. Considerations should be given to pooling and allocating aid through a development fund placed under the UN, run by a competent secretariat without day-to-day interference from its contributors, reporting to the General Assembly and audited regularly by an independent body. Such a course of action would be desirable not only because of increased involvement of the UN in development goals and social issues closely linked to world peace, but also because of its democratic nature.

Poverty reduction has been declared a global public good in several UN summits and conferences in recent years. There is thus a strong case for establishing global sources of finance. This could be achieved through agreements on international taxes, including a currency transactions tax (the so-called Tobin tax), environmental taxes and various other taxes such as those on arms trade, to be applied by all parties to the agreement on the transactions and activities concerned and pooled in the UN development fund. A common feature of these is that they are all sin taxes which would provide revenues while discouraging certain *global public bads* such as currency speculation, environmental damage or armed conflict and violence. While universal participation is highly desirable, such agreements do not always necessitate the participation of all countries. Certain sources of revenue, such as the Tobin tax, would need to be introduced globally in order to avoid arbitrage against countries adopting them, but others, including environment taxes, could be introduced on a regional or plurilateral basis.

Likewise, a fund established through international taxes could also be supplemented by voluntary contributions from governments, both in the North and the South, private foundations and wealthy individuals. Even existing IDA resources could become part of the endowment provided that the donors agree to hand them over to an independent secretariat. A relatively small endowment, reaching some USD 80 billion could generate more sources for grants to poorest countries than IDA and PRGF put together.

An advantage of such arrangements over present aid mechanisms is that once an agreement is reached, a certain degree of automaticity is introduced for the provision of development finance without going through politically charged and arduous negotiations for aid replenishments and national budgetary processes often driven by narrow interests. This is exactly what distinguishes IBRD financing which relies on once-and-for-all guarantees given by its shareholders from highly-politicised IDA.

Establishing a genuinely multilateral system of development finance is a complex issue that would require reflection, engagement and debate among all the parties concerned. In the end it is down to the political will and clout of the international community. But the first step should be to put the issue squarely on the global agenda. This has unfortunately not been the case despite proliferation of UN summits and conferences on development finance and poverty. ■