



The World Bank

By Catherine Caufield

The World Bank was created in 1945 as a lender of last resort to ensure that countries could borrow the foreign capital required to build modern infrastructures and enter into international trade. Before World War II, governments needing money borrowed from private U.S. or European banks and investment firms. But in the 1930s, after borrowers had defaulted on loans totaling hundreds of millions of dollars, much of which was spent wastefully, foreign lending dried up. To avoid a repeat of the international financial collapse that followed, the World Bank's founders (led by the U.S. and Britain) allowed loans only for "productive purposes" and for "specific projects"—projects that would produce, directly or indirectly, the foreign exchange needed for repayment.

The World Bank was not created to be an antipoverty agency, though its supporters argued that in helping developing countries become modern industrial economies, the bank would also be fostering a rise in their standard of living as wealth trickled down to the poor. To a great degree, the World Bank's public support derived from the mistaken belief that the bank's true role was to help the poor. However, by the mid-1960s,

though many developing countries had achieved quite high rates of economic growth, the newly created wealth was not trickling down and was doing little to alleviate mass poverty. In an attempt to reach the poor directly, the World Bank began making loans for education, housing, and other social services—loans it had previously rejected as unlikely to earn the foreign exchange necessary for repayment. But since the bank neither lends

nor accepts repayments in local currencies, it makes no economic sense to lend foreign capital for investments in domestic services that neither require nor produce foreign exchange.

In the late 1960s the World Bank was lending less than a billion dollars a year; by 1981 it was lending more than \$12 billion a year. That dramatic increase was only possible because as early as the mid-1960s, the Bank

began relaxing standards of creditworthiness and its notion of what constitutes a productive investment. Only by lowering its standards could the Bank continue lending to countries that were plunging more and more deeply into debt. The World Bank also encouraged private banks to step up their lending to developing countries. The resultant surge of private lending led to the debt crisis of the early 1980s, when several key borrowers threatened to default on hundreds of billions of dollars worth of foreign debt, throwing the financial world into panic.

The World Bank was created to make long-term loans for productive projects, while the role of its sister organization, the International Monetary Fund (IMF), was to make short-term, general loans to help countries through temporary balance-of-payments crises. However, when the debt crisis broke, the World Bank began making IMF-style balance-of-payments loans. The bank called these "structural adjustment loans," and they were conditioned on the borrowing country's agreeing to adopt free-market-oriented reforms covering nearly every aspect of life, from the legal system to financial regulations, from workers' rights to healthcare.

During the 1990s, more than a quarter of the World Bank's loans were adjustment loans, tied not to projects but to economic and social policy reform—despite the fact that the bank's charter forbids such loans except "in special circumstances." The World Bank uses these adjustment loans to "roll over" the bad debts of borrowing nations—thereby disguising the poor quality of the bank's own lending practices—and to impose its ideology of economic reform on its borrowers. Its dogged advocacy of free-market principles reflects the influence of the United States, its major shareholder. Although the World Bank is governed by an executive board that represents all its shareholders, the U.S. wields more influence than any other member. The bank's headquarters are only a few blocks from the White House, its president is always a U.S. citizen (as the head of the IMF is always European), and the U.S. Congress is more active than the legislature of any other country with regard to monitoring the Bank and demanding reforms of it.

Key Points

- The World Bank's Articles of Agreement (its charter) require that it lend only for productive purposes.
- The bank's nature and practice ensure that its projects will have a high failure rate.
- The bank promotes risktaking, but only for its borrowers.



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Problems with Current U.S. Policy

Unlike commercial banks, the World Bank is not merely a lender. It is deeply involved in choosing, planning, and overseeing the implementation of the projects for which it makes loans. The success or failure of World Bank-funded projects owes as much to the actions of the bank as to those of its borrowers. Failed projects often cause large-scale social and environmental disruption, delay essential investments, and waste money that might have been better spent elsewhere.

A large proportion of World Bank loans are failures. According to the bank's Operations Evaluation Department, nearly one-third of its projects and adjustment loans do not meet the minimum standard for economic productivity, and 56% are unlikely to be sustainable—that is, to deliver the predicted benefits. The percentage of unsuccessful loans would certainly be even higher if the loans were independently assessed and if their environmental and social impacts were taken into account.

In response to this extraordinary failure rate, World Bank management has pledged to increase the number of projects that meet its minimum economic standards. Yet the bank has set the goal for economically successful loans not at 100% but at 75%, reasoning that striving for complete success would stifle the innovative thinking and risk-taking needed to solve the complicated problems of developing countries. Bank officials argue that knowledge comes through trial and error, that without a willingness to experiment and to risk failure, there can be no learning—and no progress. One internal report warns that too high a rate of success in its lending program “could imply the Bank was not taking risks in a high-risk business.” It is true that in pursuing a goal as ill-defined and poorly understood as “development,” failures are inevitable. But it is wrong to imply that the World Bank is boldly taking risks. In fact, it is merely devising risks and passing them on to its borrowers. The lessons the bank has learned—some of which have been very expensive indeed—have been paid for by the poorest countries in the world. Whether a project succeeds or fails, the bank is repaid in full. The borrower alone bears the burden of failure.

The bank's excellent repayment record—no government has ever defaulted on a World Bank loan—reflects not the quality of its loans but its enormous power, not only as a lender, but also as the gatekeeper for all development loans. Borrowers dare not default, because to do so would be to risk losing the bank's imprimatur, which along with that of the IMF, has become essential for any international loan. Defaulting would make any government an international economic pariah. Moreover, defaults are not necessary when borrowers receive new World Bank loans so that they can meet payments due on old ones. This so-called “defensive lending” papers over both the poor quality of the bank's

lending practices and the consequent growth in debt among its borrowers. Indeed, fifty years of World Bank lending and advice have succeeded mainly in plunging many countries into insupportable debt. The bank now ranks one-third of its borrowers as “severely indebted,” defined as a “level of outstanding debt so high the country could not meet principal repayments as they fall due.” Almost all of these countries are so poor that they are eligible to borrow only from the International Development Association (IDA), the arm of the World Bank that makes very low interest loans to the poorest countries. In addition, the bank's management has admitted that over half of its 62 middle-income borrowing countries “could pose a risk of protracted arrears to the bank.”

Perversely, under this arrangement in which bad loans are covered up by new ones, the World Bank gains more from failed projects than from successful ones. For as its lending grows, so do its profits (\$1.3 billion in fiscal year 1997), administrative budget (now \$1.4 billion), and staff (10,000 strong)—and consequently its power and stature. The more the World Bank lends to a country, the more it can insist on being involved in domestic issues confronting the debt-ridden, supplicant borrower, from economic and financial policy, to military, social, legal, environmental, and administrative matters. In short, the bank has an incentive to lend more, not to lend well.

Rather than acknowledging its co-responsibility for the indebtedness problem, the World Bank maintains the fiction that borrowers are feckless incompetents and the Bank is an indulgent patron with all the answers. In 1995, the multilateral lending agencies (the World Bank, the regional development banks, and the International Monetary Fund) created a fund, to be co-financed by the institutions themselves and wealthy governments, to help the most heavily indebted poor countries. This special fund is available only to countries with “unsustainable debt burdens” who have first submitted to six years of strict adherence to World Bank guidelines and whose bilateral and commercial creditors have forgiven up to 90% of the money owed them. Once these conditions are met, the new fund will pay off an equal proportion of the country's multilateral debt. This fund acts as a middleman, enabling the bank and the other international financial institutions to deny that they are engaging in debt forgiveness. It also brings in outside money to help repay the riskiest debts those institutions hold.

Key Problems

- The World Bank has power without responsibility.
- Borrowers are driven to continue borrowing to repay loans made for unsuccessful projects, creating a spiraling debt burden that is crushing many developing countries
- Efforts at debt reduction are unfair, ineffective, and counter-productive.

Foreign Policy in Focus is a joint project of the Interhemispheric Resource Center (IRC) and the Institute for Policy Studies (IPS). The project depends on sales and subscription income, individual donors, and grants from foundations and churches. *In Focus* internships are available, and we invite article queries and comments. ISSN 1524-1939

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Toward a New Foreign Policy

In many cases, the appropriate way to fund attempts to solve domestic social problems is through outright grants, or through loans that can be repaid in local currency. The United States should press the World Bank to stop making foreign exchange loans for its projects. The bank should accept repayment in local currency, make outright grants, or allow agencies to deal with projects that do not require foreign exchange. That would reduce the foreign indebtedness problem that underlays the massive pressure for the World Bank—and other international development agencies—to lend ever more, and the resultant growth in expensive, failed loans.

In refusing to accept responsibility for its actions, the World Bank contradicts its own rhetoric on good govern-

nance. It presses borrowers to move toward financial accountability as a key component of sound management, but it clings to its own privileged position of no accountability. Sheltered from the pressures of a healthy market system, the World Bank suffers from the same inefficiencies it deplores in many of its borrowers. When decisions are not contingent upon financial considerations, political and bureaucratic concerns come to the fore, as they

did in the centrally planned economies, whose demise the bank offers as evidence of the superiority of free market economies. The World Bank must bear some part of the cost of the damage—financial, social, and environmental—done by the projects and programs it helps to design. Until it is held financially accountable, it will have no real incentive to improve the quality of its lending, and the vicious cycle of defensive lending and escalating debt will continue.

The World Bank has always maintained that it cannot forgive debts, though it has been engaging in stealth debt forgiveness for decades via recycled loans and arm's-length payoff schemes. It is true that an open policy of debt forgiveness would require an amendment to the World Bank's Articles of Agreement, but these have been amended several times. Nor would accountability necessarily spell doom for the bank. Commercial banks forgive debts—often at the World Bank's urging—and experience defaults, and manage to survive. Moreover, it is not suggested that the World Bank go as far as commercial lenders, who sometimes have to cover defaults that occur through no fault of their own. Instead, the World Bank is merely asked to take responsibility for damage caused by its own actions or advice.

Though the World Bank argues that this is unworkable, the mechanism for implementing accountability could

be quite simple. Loans for projects that repay their investment and have no costly social or environmental side-effects pose no problem. When projects fail, however, the bank and the borrower should attempt to isolate the errors and apportion the damage done by each party. Ideally, the two sides would agree on the allocation of responsibility. If this is not possible, the matter could go to arbitration. The World Bank's Articles of Agreement already stipulate that disagreements between it and its borrowers should be submitted to arbitration. Once responsibility has been apportioned, the bank could either reduce principal repayments by the amount of compensation agreed upon or pay the borrower compensation for its share of the damage while the borrower continues making repayments as originally intended.

Kunibert Raffer, professor of economics at the University of Vienna, has proposed the establishment of a permanent international court of arbitration to deal with these issues (not only for the World Bank, but also for the regional development banks and other international financial institutions). Such a court would hear complaints and take evidence not only from governments but also from non-governmental organizations and private citizens.

A greater challenge is the allocation of responsibility for damage caused by large-scale reform programs that have failed and driven a country into insupportable debt. Often in such a situation, other creditors agree to some debt forgiveness simply to keep the economy—and thus the chances of at least a partial repayment of outstanding loans—alive. In these circumstances, the World Bank should reduce its debt by the same proportion as other public lenders.

A number of analysts, notably Rep. Jim Leach (R-IA), chair emeritus of the Financial Services Committee, have advocated an international law permitting sovereign governments to declare bankruptcy. This would enable overburdened governments to regroup and eventually repay at least some of their debts. The U.S. has long had such a law, known as Chapter 9 of the Bankruptcy Code, for municipal governments, which gives the residents, taxpayers, and employees of the insolvent government a right to be heard before a bankruptcy judge, who decides how much money creditors can reasonably expect to receive under the circumstances. Raffer has outlined how Chapter 9 could be adapted to international use.

Only the knowledge that there is a significant cost to poorly planned loans will significantly improve the way the World Bank operates and give its borrowers a chance to escape from the destructive cycle of unproductive borrowing and crushing debt in which they are now caught.

Catherine Caufield is author of the 1997 book, Masters of Illusion: the World Bank and the Poverty of Nations.

Key Recommendations

- The World Bank should be accountable for its actions.
- The bank should forgive loans in proportion to its responsibility for their failure.
- There are existing legal mechanisms that could be adapted to this purpose.

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Catherine Caufield, *Masters of Illusion: the World Bank and the Poverty of Nations* (Holt, 1997).

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