The London School of Economics and Political Science

The business of development: Borrowers, shareholders, and the reshaping of multilateral development lending

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Declaration

I certify that the thesis I have presented for examination for the MPhil/PhD degree of the London School of Economics and Political Science is solely my own work other than where I have clearly indicated that it is the work of others (in which case the extent of any work carried out jointly by me and any other person is clearly identified in it).

I warrant that this authorisation does not, to the best of my belief, infringe the rights of any third party.

I declare that my thesis consists of 75,914 words.

Statement of conjoint work

I confirm that Chapter 3 was jointly co-authored with Dr. Katharina Michaelowa of the University of Zurich, and I contributed 70% of this work.

Abstract

This thesis seeks to understand how shifts in global economic power affect the policies and practices of multilateral development banks (MDBs). The study proposes three hypotheses. First, the "business" of development lending has changed radically in recent years as a result of the rise of middle income economies that now have a variety of options for sovereign borrowing—a reality thus far largely overlooked in academic research on MDBs. Second, a key factor defining the operational characteristics of the 20-odd MDBs in existence is the relative balance of power between borrower and non-borrower shareholders in MDB governance. Third, the financial pressures inherent in MDBs' organizational models limit the options for MDB operations and shape how they will react to evolving market conditions.

To test these hypotheses, the study examines several inter-related areas of MDB history and current operations, using as cases the World Bank (controlled by non-borrowing countries), the Inter-American Development Bank (control divided between borrowers and non-borrowers) and the Andean Development Corporation (controlled by borrowing countries). The analysis of the MDBs is complemented with case studies of Colombia and Ecuador, two countries with extensive borrowing histories with all three MDBs, to understand the demand side of development lending from the point of view of borrowing country government officials.

The thesis finds compelling evidence in support of all three hypotheses, which suggests that the prevailing academic view that MDBs can be understood by focusing on the organization itself while ignoring the views of borrowers is not sufficient to understand the complexities of multilateral lending. MDBs are not all-powerful, but rather one resource among many at the disposal of governments to further their development, with varying competitive characteristics that impact the demand for their loans by borrowing countries in the current global context.

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Zurich, 8 March 2013

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1 Introduction

In academic literature as well as general public perception, the World Bank and other multilateral development banks (MDBs) have long been viewed as domineering organizations able to impose themselves upon developing countries. Since the mid-1990s, however, a number of developing country governments have found themselves in strong financial positions, due to the huge rise in global private capital flows and high foreign exchange income from rising commodity prices and growing export industries. Whether these trends represent a cyclical upswing or a more fundamental shift in the world economy remains to be seen. But there is little doubt that the demand for multilateral lending from many major developing countries is undergoing a structural change. Economies such as China, Indonesia, Brazil, Mexico and Turkey—which together accounted for 43% of the World Bank's loan portfolio in 2009—now have strong fiscal accounts, low public debt levels, high international reserves and well-established access to international capital markets.

Little attention has been paid in academic literature to how this sea change in economic conditions for many developing countries might impact MDB lending. Scholarship has instead focused on how MDB lending decisions are influenced by geopolitical considerations of powerful shareholders, by bureaucratic pathologies within MDBs or by changing ideologies on development, among other factors. All of these approaches implicitly assume that lending fluctuates only due to decisions taken by the MDBs or their principal shareholders, while the preferences of borrowing countries are not relevant. This may have been justifiable in the 1980s, when access to capital by developing countries was highly restricted, but is unlikely to be realistic in the current global context.

The thesis takes this insight about the importance of borrower country demand as a point of departure for analyzing multilateral development lending. How are changing economic conditions in developing countries impacting MDB lending trends, and why? What do countries look for from MDB loans, and what might make them choose to take out a loan or not? Is this change in borrower need impacting the finances of MDBs, and is that in turn leading them to change their behavior to continue being attractive as a source of loans? Academic research is as yet silent on these issues, despite their far-reaching implications for the activities of MDBs and on international development more broadly. The thesis does not suggest that the "supply side" analysis prevalent in the existing literature is misguided—the empirical results of numerous studies clearly show that they have considerable merit—but rather that fully explaining MDB activities in the present day requires complementing these analyses with a better understanding of the preferences of borrowing countries.

In developing a demand-side approach, I propose a theoretical framework considering multiple MDBs and suggesting that differences in operational characteristics between them may be partly explained by the balance of power between borrowing and non-borrowing country shareholders. The vast majority of scholarship related to MDBs has focused exclusively on the World Bank, and little attention has been paid to the 20-odd other MDBs, despite their considerable importance to many countries. Are different MDBs being affected in different ways by the changing global economic context? Do borrowing countries prefer working with some MDBs over others in different situations, and if so, why? To systematically compare MDBs, the thesis develops a new typology based on shareholding structure. This governance structure directly influences the characteristics of loans that most directly impact borrower demand—i.e., financial cost and required bureaucratic procedures. MDB shareholder arrangements are divided into three types: (1) domination by wealthy non-borrowing countries (at the World Bank); (2) more balanced influence of borrowing and non-borrowing countries (at the Inter-American Development Bank, IADB); and (3) control by borrowing countries (at the Andean Development Corporation, CAF). The operational characteristics of each MDB derived from these shareholder arrangements, I suggest, strongly condition the preferences of countries to borrow from them.

A third new approach taken by this thesis is to take seriously the fact that MDBs are, among other things, organizations with a unique financial structure that deeply shapes that way they act. MDBs are, after all, banks—a fact that much scholarship overlooks. The MDB model, first created with the World Bank in 1944 and since replicated in roughly 20 other organizations, has proved remarkably popular in good measure because it is mostly self-financing: MDBs raise money on capital markets very cheaply, then on-lend at a slightly higher but still attractive financial terms, and use the margin to pay administrative costs. They require only minimal and occasional budgetary contributions from member governments. The world has come to expect MDBs to provide development finance and a number of critical global public goods (such as development expertise, disaster relief and environmental coordination) that are financed almost entirely through the income that MDBs earn from their operations, and not by contributions from governments. How have the financial imperatives facing MDBs affected their development mission? Does the need to access capital markets impact their activities, and if so, how? Is declining demand for lending of some MDBs hampering their ability to finance themselves? Are MDBs changing their behavior and competing to make more loans for financial rather than developmental reasons?

The subsequent sections of this introductory chapter review existing academic theory and empirical research on international organizations and MDBs (1.1), and then develop testable hypotheses based around the three issues discussed above (1.2). The next section (1.3) outlines the empirical research strategy to be pursued in the subsequent five chapters, while the final section of the introduction (1.4) provides an outline of the governance structure of the three MDBs analyzed in the thesis.

1.1 Theoretical Framework for Analyzing MDBs

The following section lays a theoretical foundation on which I subsequently build hypotheses to test in the analytical chapters of the thesis. The first sub-section provides a definition of MDBs, and the next gives an overview of the academic literature analyzing the activities of MDBs and discusses its relevance for the current research project. Based on this discussion, I then develop a new theoretical framework for understanding MDBs that focuses on the balance of power between shareholding countries and the increasing importance of demand-side considerations in the MDB-country relationship. As well, I build on aspects of sociological theory to explain actions taken by MDBs to secure the resources they need to survive and thrive.

1.1.1 Defining an MDB

Multilateral development banks are a unique group of international institutions created in the wake of World War II. One useful definition, adopted by this thesis, is as follows:

"Multilateral development banks are international financial intermediaries whose shareholders include both borrowing developing countries and donor developed countries. They mobilize resources from private capital markets and from official sources to make loans to developing countries on better than market terms, they provide technical assistance and advice for economic and social development, and they also provide a range of complementary services to developing countries and the international development community." (IDS, 2000, p. 4)

The first MDB created was the International Bank of Reconstruction and Development (IBRD, the principal component of the World Bank), followed in later years by other MDBs in various parts of the world. About 20 MDBs currently exist—one global MDB (the World Bank), several large regional MDBs and several sub-regional MDBs (IDS, 2000). The essential characteristic of the IBRD, and one which has been replicated in all other MDBs, is that it channels capital to developing country governments at a lower cost than they could access themselves on the private markets. The mechanism for doing this coordinates among a group of national governments in such a way to produce an outcome that was not possible through the functioning of private markets. Shareholder governments commit a certain level of capital to the organization, a small percentage of which is actually transferred ("paid-in capital"), while the majority is to be made available if needed ("callable capital"). The MDB can then use i) this capital, ii) the creditworthiness of the totality of member countries, and iii) its own market reputation to raise capital on private markets at favorable rates. This capital is in turn lent on to borrowing country governments at terms (usually) better than they could get on their own.

One key trait that has made the MDB model so attractive to member governments is that it is largely self-financing. Administrative costs are paid for by the interest and charges from MDB financial operations, and wealthy countries are not required to contribute to these costs, other than occasional increases to the capital of the organization if its shareholders wish to expand lending capacity.[1] The guarantee capital of any of the MDBs never been called on in their history, and the percentage of paid-in capital has steadily declined. Hence the direct cost to wealthy countries is small, while the benefits they receive—furthering their geopolitical, economic and developmental agendas through an international organization—are considerable (on the direct financial costs of the World Bank to shareholders, see for example Gilbert et al., 1999; Kapur, 2002; and Mohammed, 2004). The need for MDBs to i) secure access to financial markets to access needed capital and ii) maintain relevance to borrowing countries so as to generate sufficient loan income are key factors underpinning this thesis. The ability of each MDB to successfully undertake these two tasks, in light of their particular shareholding composition and operational characteristics, are the main topics to be explored in the subsequent chapters.

1.1.2 Overview of Scholarship on International Organizations

The following sub-section provides an overview of several pertinent theoretical approaches heretofore applied to MDBs in academia, and discusses their advantages and shortcomings for the current research project. Based on this discussion, I then develop a new theoretical framework for understanding MDBs that focuses on the balance of power between shareholding countries and the increasing importance of demand-side

[1] Shareholders do regularly contribute to concessional lending windows for the poorest countries of some MDBs, namely the World Bank's International Development Association (IDA) and the IADB's Fund for Special Operations (FSO), which do not generate net income, as well as to trust funds established for specific purposes.

considerations in the MDB-country relationship. As well, I build on aspects of sociological theory to explain actions taken by MDBs to secure the resources they need to survive and thrive as organizations.

The existing academic literature posits a wide range of theoretical viewpoints to explain MDB activities, which is to be expected. Situated as they are at the junction of international politics, the global economy and the development prospects of millions of the world's poor, it would be surprising indeed if a single theoretical model were adequate to satisfactorily explain MDB behavior. Approaches include realist considerations of power politics and donor interest (Krasner, 1981; Dreher et al. 2009a and 2009b; Kilby, 2006 and 2011, among many others), a rationalist focus on the rules of the game and incentives among main actors in MDB activities (Mosley et al., 1995; Gutner, 2005; Vaubel, 2006), or more sociology-based constructivist interpretations of norms, professional self-image or organizational adaptation (Barnett and Finnemore 1999 and 2004; Babb, 2003). A growing number of scholars are combining constructivist and rationalist approaches (Chwieroth, 2005; Nielson et al., 2006; Weaver, 2008). These theoretical approaches all have considerable merit, as the evidence found in their support suggests. The purpose of the present thesis is not to argue against their validity, but rather to draw attention to what I see as three important theoretical and empirical gaps, that if filled will offer a more complete understanding of how and why MDBs act in the way they do.

First, it is notable how little existing research considers MDB activities from the point of view of the borrower. The vast majority of research on MDBs from all three theoretical traditions mentioned above presupposes that all countries eligible to borrow from an MDB will always want to do so, and the important question to be asked is what factors might lead an MDB to award a loan to a country or not. That is, they focus almost entirely on the "supply side" of MDB activities, whether it be the geopolitical interests of powerful MDB shareholders, the tensions between shareholders and MDB staff or the bureaucratic tendencies and pathologies of MDBs themselves, among others.

In light of the spectacular growth of many large developing countries in recent years as well as the explosion of international capital flows, the scenario of a constant demand function by borrowers is unlikely to be realistic now. Many large developing countries that have been major borrowers from MDBs in the past have in recent years found themselves in much stronger fiscal positions and also with a great many options for sovereign borrowing, often at very low interest rates. If, for example, China does or does not receive loans from the World Bank, one suspects that this has a lot more to do with China's own calculations rather than any decision by the World Bank's board. Hence, a more realistic and complete picture of how MDBs function in the global context of the 21st century requires understanding the role played by borrower demand. Why, when a country has a choice, might it borrow from an MDB or not, and why might it prefer borrowing from one MDB over another?

That broad economic shifts are impacting development lending is not news to the MDBs themselves. Since 2000, for example, the World Bank has published numerous strategy papers and undertaken several major reforms specifically in an effort to maintain its attractiveness as a development lender for middle-income countries, including the Cost of Doing Business studies (World Bank, 2001a and 2007a), the Middle-Income Country reviews and strategy (World Bank, 2001b and 2004a), the Investment Lending Reform (World Bank, 2009a) and the recently-approved Program for Results (World Bank, 2011a), among others. More policy-oriented researchers and journalists who follow development issues have also noted these changes, including among others the Center for Global Development (2005), Mallaby (2005) and Einhorn (2006).

However, academic research has as yet not reacted in a significant way to the increasing importance of borrower demand. The overwhelming focus of recent academic papers on MDBs has been the role played by major industrialized shareholders in influencing which countries receive loans (for example, Harrigan et al., 2006; Kilby, 2006 and 2011; Dreher et al. 2009a and 2009b; and Babb, 2009). The assumption underpinning all these studies—that countries always want MDB loans and the issue is only whether the MDB deigns to loan to them—seems in need of an update in light of changed global realities.

The only academic research that explicitly considers the role of demand are Mosley et al.'s (1995) fascinating study of World Bank structural adjustment loans in the 1980s and Ratha (2005) and Knack et al.'s (2012) statistical analysis of demand for World Bank loans. Mosley et al. (1995) use in-depth qualitative analysis and game-theoretic modeling to analyze the bargaining process between recipient countries and the World Bank in the design and implementation of structural adjustment programs. In this case the leverage of borrowers came not from reduced financial demand or other options for borrowing, but rather their awareness of the incentives and limitations faced by World Bank officials in their efforts to impose policy conditionality. Ratha (2005) and Knack et al. (2012), by contrast, do explicitly consider variations in demand, by bringing to bear statistical tools to model demand for World Bank loans with aggregate economic indicators as independent variables. While none of these studies directly address the questions posed in this thesis, they do provide very useful insights that I propose to build on, particularly in the country case studies (following Mosley et al.'s lead in attempting to understand the complex political economy motivations of borrowing governments) and in the statistical analysis of MDB lending trends (building on Ratha's and Knack et al.'s statistical framework and applying it to three different MDBs, instead of just one).

A second shortcoming of existing literature is a single-minded focus, on the one hand, on the World Bank, and on the other on the United States and a handful of other powerful countries as the only powerbrokers of importance at the World Bank. That the World Bank is hugely important as a development institution and as a lender to developing countries—with a loan portfolio of nearly US$200 billion—cannot be disputed. But other MDBs operate in the world, and in many regions they lend as much or more than the World Bank. Thus it seems appropriate to branch out research to these other MDBs, and seek to understand how their activities and characteristics compare to those of the World Bank. Some academic and policy research has moved in this direction (for example Nelson, 2000; Gutner, 2002 and 2005; Neumayer, 2003; Adams, 2005; Kilby, 2006 and 2011; and Lim and Vreeland, 2011, among others), but considerably more needs to be done.

While these studies are positive steps to branching academic research out beyond the World Bank, most focus on one institution and do not make significant effort to understand whether, how and why they might differ from one another. Exceptions include Krasner (1981), but that study makes no pretense of being an in-depth piece of comparative research, and rather takes different MDBs as a simple example of realist geopolitical considerations. Babb's study of the World Bank and the major MDBs (2009) focuses mainly on the role of the U.S. in shaping MDB policy, and groups all the MDBs together as "the banks" without any meaningful attempt to differentiate among them. The only academic studies to date that systematically compare the activities of different MDBs to one another are Gutner's (2002) book on environmental projects by different MDBs in Europe and Nelson's (2000) comparison of civil society policies at the World Bank and IADB. Policy-oriented work has considered variance of different MDBs (notably IDS, 2000 and Griffith-Jones et al., 2008), but an analysis of the political economy factors shaping the structure and activities of different MDBs, as this thesis proposes, is lacking.

Another tendency in the existing literature is an almost exclusive focus on the United States, or most the G7 countries, as the only shareholders of interest when considering MDBs. However, as Lyne et al. (2009) point out in relation to the World Bank, the U.S. is far from being the only shareholder able to influence an MDB. Gutner (2002) makes a similar point in her study of MDBs in Europe, as does Copelovitch's (2010) study of the IMF. Lyne et al. highlight the "complexity" of principals and take seriously the formal composition and rules of MDBs as a means of explaining a shift in social policy lending through the collective preferences of all shareholding countries. This is a valuable contribution. In many countries in the world, the United States and the G7 countries have no particular political or economic agenda. Powerful shareholder countries cannot possibly be involved in the myriad different projects taken on by the World Bank or other MDBs—they don't have the time or the interest. Reducing MDBs to the interests of one or two major shareholders is unlikely to take us very far in understanding their multifaceted character and actions. At the same time, following the lead of Lyne et al.

(2009) would be extraordinarily difficult to operationalize, considering the high number of shareholders in each MDB—how does one realistically aggregate and weigh the preferences of the World Bank's nearly 200 shareholders on every issue of interest?

Some scholars (including Kapur, 2000; Stone, 2008; and Babb, 2009) would argue that analyzing formal voting rules and shareholdings in the style of Lyne et al. (2009) and Gutner (2002) is misguided because, as they suggest, many decisions made at MDBs and other IOs are done through the exercise of informal power, especially by the U.S. While it is undeniable that the U.S. does have informal levers of power in these institutions (through its dominant economic, political and military position in the world), these do not render formal mechanisms and voting power irrelevant. This thesis shows that formal voting rules and power are critically important variables in determining characteristics of each MDB, a point that is further substantiated by the bitter ongoing disputes among countries about even very small changes in voting share. Further, what several of these scholars term as "informal" U.S. power at the IADB and World Bank is in fact its formal veto power over changes to the Articles of Agreement and capital structure, and its threat to use that veto if other shareholders do not accede to its demands in areas where it does not have a veto.[2] Thus, while informal power likely does exist in the governance of MDBs, formal voting structures and power remain fundamental to explaining their policies and actions, as this thesis will demonstrate.

Third, it is notable how little existing research even mentions, much less analyzes seriously, the character of MDBs as financial institutions. With a very few exceptions (for example, Kapur, 2002; Mohammed, 2004; McKenzie, 2004; and Bulow and Rogoff, 2005), most researchers appear to be either unaware or discount the importance of the self-financing character of MDBs, and what this might imply for their operations. Yet this trait is one of the reasons MDBs have been so successful: they impose very little direct fiscal costs to wealthy countries, and undertake the provision of what is generally considered a global public good, i.e. development assistance. This trait also makes MDBs particularly difficult to control—shareholder countries do not, in the end, have the

[2] For more details on shareholding and voting structures, see Section 1.5 of this chapter.

"power of the purse" in the same way that they do over other international bureaucracies, such as the United Nations. The main lending windows of most MDBs[3] fund themselves from the proceeds of their loans and raise resources to lend on private capital markets, and thus do not depend on regular budgetary allocations from shareholders. So in a very real sense, MDBs must act in part as "profit"-seeking, or at least revenue-seeking.[4] This can go part way to explaining the motives of the MDB "agent", which as constructivists point out is often a weakness of principal-agent models: "The problem with applying principal-agent analysis to the study of IOs is that it requires a priori theoretical specification of what IOs want. Principal-agent dynamics are fueled by the disjuncture between what agents want and what principals want. To produce any insights, those two sets of interests cannot be identical" (Barnett and Finnenmore, 1999, p. 705).

The literature arising out of organizational sociology addressing how organizations cope with resource constraints can help analyze how MDBs may react to evolving financial pressures in ways that are not necessarily in line with the interests of some or all of their principals. Several authors—notably Pfeffer and Salancik (1978) and more recently Barnett and Coleman (2005)—emphasize that the drive to ensure necessary external resources can strongly shape the strategies and activities taken by an organization as well as individuals within it, even if these strategies and activities are not always in line with the organization's mission. For an MDB, the critical external resources needed to ensure organizational autonomy and survival are: i) an ability to float its bonds on private capital markets to raise capital for lending and ii) a portfolio of income-generating loans. This thesis does not pretend that resource capture is the only factor motivating MDB agents—more constructivist-oriented issues such as, for example, the evolution of development norms and professional self-image of MDB staff also likely play a role, as discussed for example by Barnett and Finnemore, 2004, Woods, 2006 or Weaver, 2008. But it would be surprising indeed if the changing ability of MDBs to ensure these two essential

[3] This is not the case for concessional lending windows, IDA and FSO, as will be discussed in detail in Chapter 4.
[4] All MDBs are formally non-profit organizations. The constituent agreements of all three MDB studies here do permit year-end dividend divisions to shareholders, although in practice this does not occur. See Chapter 4 for a more detailed discussion of net income uses.

resources did not have an important impact on their activities, and this has thus far been a topic of minimal academic research.

1.2 Hypotheses

This study proposes a new framework for understanding variance among MDBs, based on the three points discussed above. It maintains that borrowing country preferences are increasingly important in understanding MDB activities, and must be brought into the forefront of analysis. The study attempts to categorize MDBs in a way that systematically explains aspects of their operational characteristics or "competitive advantages" that might influence borrower demand according to the composition of their shareholding countries. Extending the concept of complex principals described by Lyne et al. (2009) in a way that makes it simpler and more realistic to operationalize, I suggest that the balance of power between non-borrowing and borrowing shareholders in each MDB shapes how otherwise similar organizations operate, in ways that impact the demand for their services by borrowers.

While all countries have their own particular interests and agendas, the dichotomy between borrowing and non-borrowing countries seems particularly important in the context of an MDB, defining two important groups of shareholders that will tend to have opposing interests. Borrowing governments will want MDBs to supply loans and advisory services at as low a cost as possible, with minimum bureaucratic hassles and conditions. Non-borrowing countries, by contrast, will seek to impose their own ideas about development on borrowers, implement strict control on how resources are spent, and reduce the risk of MDB financial difficulties that they would have to pay for out of their guaranteed capital. The relative power of those two groups, I suggest, is a critical variable shaping the competitive advantages of different MDBs from the point of view of borrowing countries. Further, the insights from organizational sociology and the bureaucratic imperative of securing essential resources suggests that MDBs are not simply passively being buffeted by the winds of changing economic contexts or shareholder power, but actively seeking to adapt and survive.

Based on this discussion, the study seeks to test the following three over-arching hypotheses, the first of which focuses on the internal dynamics of MDBs while the second two address how MDBs relate to borrower countries and the wider external environment in which they operate. The two sets of hypotheses are linked, in that the causal relationships defining the internal dynamics of each MDB in turn condition its relations to borrowers and the external environment.

I. Shareholders and internal MDB dynamics

H1: The balance of power between borrowing and non-borrowing shareholders causally defines key MDB operational characteristics that impact borrower demand, including loan cost and approval requirements, such that:

- The more non-borrowing countries have control over an MDB, the lower will be loan prices, but the more intrusive will be its loan approval requirements
- The more borrower countries have control over an MDB, the higher will be loan prices, but the less intrusive will be its loan approval requirements

II. MDBs, borrowers and the external environment

H2: As a function of a borrowing country's reduced need for MDB loans and greater access to alternative sources of capital, these MDB operational characteristics will become increasingly important in explaining their demand for MDB loans, as opposed to supply factors.

H3: The imperative of securing resources required for MDB organizational survival (i. sources of capital and ii. borrowing country clients) will lead MDBs to modify their operational strategies, organizational structure and even membership to ensure survival.

These three hypotheses are clearly falsifiable by evidence gathered during research. Should the hypotheses turn out to be false, it may suggest that other aspects of institutional design are more important than the ones I highlight. Evidence could also suggest that the entire institutionalist approach is misguided, and that realist or constructivist viewpoints are more germane. Perhaps, for example, major shareholding countries are actively engaged in manipulating MDB actions on a more micro level than I imply for reasons of geopolitical interest, or that new strategies for MDBs are almost entirely driven by development economists re-conceptualizing their role in a changing environment. Thus, whatever the result, testing the hypotheses should provide relevant evidence in favor or against the hypotheses outlined above.

1.3 Research Agenda

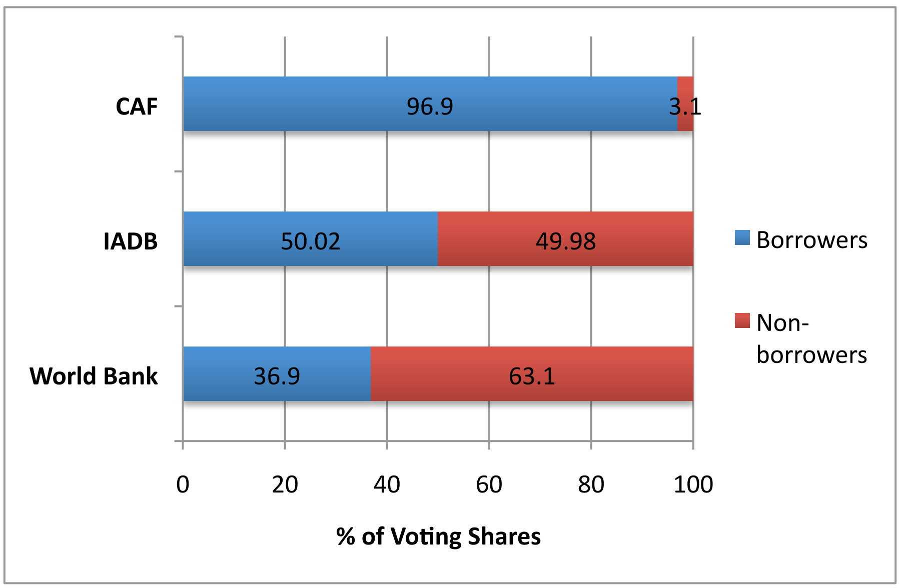
1.3.1 Delineating the Area of Research

In broad terms, the project will examine financial trends of MDBs and of borrowing countries, and attempt to correlate the behavior of MDBs to those trends in a way that provides evidence for or against the three hypotheses. A logical first step, then, is to choose a set of MDBs that vary in size and shareholder composition, operating in the same marketplace for development lending. The Latin America and Caribbean (LAC) region provides a particularly useful case of a single marketplace with multiple MDBs with which to test the hypotheses, for a number of reasons:

- LAC has three different levels of MDBs—one global (World Bank), one regional (IADB) and three sub-regional (CAF, Banco Centroamericano de Integración Económica and the Caribbean Development Bank). All these MDBs lend for a variety of different types of projects to many countries within the region.
- The three largest of these MDBs—World Bank, IADB and CAF—offer a continuum of balance of power between non-borrowing and borrowing shareholders. The World Bank is controlled by non-borrowers (63% of votes in 2009), the CAF by borrowers (96.9% of policy-deciding voting shares) and the IADB roughly evenly split between the two (50.02% borrower and 49.98% non-borrower, though with the U.S. holding veto power over changes to the capital structure) (Figure 1.1). Thus they offer an excellent test case for the hypotheses by providing variation among shareholding arrangements.
- LAC is a major market for multilateral lending (US$13.6 billion in IBRD lending in 2010 by the World Bank, 24% of the global total and the most of any region in the world). Thus, if MDBs are facing financial pressures due to a changing world economy, it would be felt in LAC.

- LAC as a region has moved from a position of extreme dependence on MDB lending (the 1980s and parts of the 1990s) to one of relative strength (2001-2008). This change over time could provide a useful contrast with which to highlight both the changing demands of borrowing countries as they become less dependent on MDBs as well as the changing strategies of MDBs themselves to hold onto financially important client countries.

Figure 1.1. Borrower vs. Non-Borrower Voting Shares, 2009



Source: World Bank, IADB and CAF annual reports, 2009.

1.3.2 Organization of the Thesis

Having selected the LAC region and the World Bank, IADB and CAF, this study undertakes several inter-linked research projects in each chapter to gain traction on the three hypotheses outlined above. Chapter 2 takes a more historical approach to understanding how the MDB model evolved for each of the three MDBs, converging on a relatively similar organizational structure in response to external pressures. The subsequent chapters then attempt to understand how, within this broader "family resemblance", the three MDBs differ from one another. Chapter 3 addresses this using statistical analysis of lending trends, while Chapters 4 and 5 use more qualitative techniques to understand the operational characteristics of each MDB that result from its shareholding structure, which are driving these lending trends. Chapter 6 also attempts to understand the causes of the same lending trends, but with a focus on the perspective of borrowing countries.

1.3.3 Summary of Chapters

Chapter 2. Financial Pressures and Organizational Convergence in Multilateral Development Banks

The first research chapter of the thesis takes a historical approach to understanding how the three MDBs were initially created, analyzing the influence of financial pressures and shareholder interest. In this chapter, financial pressures are not those caused by changing borrower demand—the main issue of interest for the rest of the thesis—but rather by the need for each MDB to secure access to sufficient capital resources needed to make loans. As will be illustrated, the need to raise capital forced all of the MDBs to fundamentally change their operational style and even shareholding structure in ways that the founders had not intended, providing evidence in support of Hypothesis 3. Understanding the financial foundations of the MDBs provides a window into a little-analyzed but fundamentally important aspect of MDBs, and also sets the stage before moving forward to more recent years in later chapters, when issues of borrower demand and differential operational characteristics of each MDB becomes increasingly important. The evidence used in this chapter is gathered from both primary and secondary sources, including annual reports, interviews and speeches, policy documents, media stories and scholarly articles and books.

Chapter 3. Lending Trends by Multilateral Development Banks in Latin America, 1991-2010

This chapter uses statistical methods to seek evidence for testing the first and second hypotheses, by examining trends in sovereign lending commitments by the three MDBs over a period of 20 years among five countries in Latin America. Several sub-hypotheses are derived on how lending trends might be expected to behave during different economic conditions, based on characteristics of each MDB and borrower preferences, and then tested with multivariate regression methods. A number of control variables are also included in the regressions. The results lend support for the idea that borrowers do differentiate between MDBs in certain economic circumstances, and that they appear to do so in ways that are largely consistent with the hypotheses. However, the analysis does not purport to establish direct causal links—rather, it simply shows that the outcomes are generally consistent with what the hypotheses would predict. Further, statistical methods are unable to fully disentangle supply-side from demand-side effects in MDB lending trends. The subsequent chapters will take up these two issues in more detail, using mainly qualitative research techniques.

Chapter 4. The Politics of Loan Pricing at Multilateral Development Banks

Most academic research on MDBs pays scant attention to the fact that the main reason countries borrow money from MDBs is simply that they offer inexpensive loans. Hence, when examining factors that might shape borrower demand among different MDBs, price should obviously be high on the list. This chapter explores how and why prices for loans from the World Bank, IADB and CAF differ. One might assume that factors affecting price are relatively mundane and technical, but they are in fact highly political and directly related to the composition of shareholders in each of the three MDBs, as suggested by Hypothesis 1. These political economy factors result in loan prices different from what one might expect. To analyze these issues, the chapter relies on pricing data, MDB documents related to loan cost and income allocation, annual reports, credit rating agency reports and extensive interviews with MDB financial staff, MDB shareholders and credit rating agency analysts.

Chapter 5. Non-Financial Characteristics of MDB Lending

While price is clearly a key factor impacting the demand for MDB loans, it is far from the only one. Governments that wish to borrow from an MDB must also contend with an array of procedures and requirements that do not exist when borrowing from a private financial institution or issuing a sovereign bond on domestic or international capital markets. These include lengthy processing times and bureaucratic hurdles, environmental and social safeguards that in some cases are above and beyond national law, and tightly controlled procedures for how the proceeds of loans can be spent by the borrower. As internal studies by the MDBs themselves reveal, these non-financial bureaucratic hassle factors are impacting loan demand, especially in recent years as many countries find themselves in stronger economic positions. What's more, these factors vary widely in each of the three MDBs, and evidence suggests this variance is directly linked to shareholder interests and relative power, again supporting Hypothesis 1. Research for this chapter is based on extensive interviews with MDB shareholder representatives and MDB staff, MDB policy statements and studies and some analysis and reports from MDB watchdog non-governmental organizations.

Chapter 6. Case Studies of Borrower Demand: Colombia and Ecuador

The previous two chapters established that a number of important MDB operational characteristics are clearly linked to varying shareholder interest, as posited by Hypothesis 1. The implicit assumption in these chapters, and in Chapter 3, was that these characteristics are indeed important in shaping borrower demand when countries are in a position of relative economic strength, as suggested by Hypothesis 2. However, this is a key point to establish with direct evidence, which is the main task undertaken by the two case studies. The two countries were chosen because i) both have a long history of borrowing from all three MDBs; ii) they have both faced difficult economic times in the recent past but are currently in a strong position (thus showing variance over time); and iii) they exhibit very different political inclinations, which helps isolate the role that could be played by policy stance and/or geopolitical position. The evidence gathered—derived mainly from interviews with high-level past and current government officials in charge of multilateral borrowing—suggests that the assumptions about the importance of MDB characteristics were indeed valid in the ways assumed in the previous chapters. However, the case studies provide interesting evidence on how a government might prioritize these characteristics for reasons specific to a country's political and economic juncture, and also points to other MDB characteristics that might need to be taken more into account in future research. Further, evidence from these cases suggests that MDBs are actively engaging in strategic actions and behavior to maintain lending relationships in the face of softening demand, which further supports Hypothesis 3 and also could provide a fruitful path for further research into MDBs as they face a changing world economic context.

1.4 Shareholder Composition and Voting Rules

Before moving on to the content chapters of the thesis, it is first important to provide a brief overview of the shareholding structure and basic voting rules for each of the MDBs to be analyzed. The below section is not intended as a comprehensive analysis of voting rules in each MDB—some of which are extraordinarily arcane—but rather a basic outline to set the stage for later analysis.

1.4.1 World Bank

The main lending branch of the World Bank, the International Bank for Reconstruction and Development (IBRD), is governed by the Board of Governors with representation from each member country (usually in the person of finance ministers or central bank governors). The Board of Governors meets once a year, during the Annual Meetings of the World Bank and IMF in the fall of each year. While the IBRD Articles of Agreement give the Board of Governors complete control over the IBRD, it normally only addresses a small number of high-level issues. These include changes in capital structure and voting power, modifications to the Articles of Agreement, admission of new members or suspension of existing members, and determining the allocation of annual net income. The day-to-day running of the IBRD, including approval of all lending operations and the vast majority of policy decisions, is delegated by the Board of Governors to the Board of Executive Directors, which sits in permanent session at the World Bank headquarters (normally board meetings are held twice a week). The voting power of countries on the Board of Governors and Board of Executive Directors is exactly the same.

Voting power in the IBRD is allocated roughly in line with each country's financial contribution to capital.[5] The relative balance of power between borrowing and non-borrowing countries on the IBRD board has not changed substantially in the past 30 years (Figure 1.2). Borrowing countries have seen a marginal increase in voting power over recent decades, but still only have a bit more than 1/3 of the total votes. Thus non-borrowing countries can easily control all decisions decided by a simple majority, which includes essentially all changes to operational and financial policy and the approval of all individual loan or non-loan projects. Several issues require more than a simple majority for approval, according to the IBRD's Articles of Agreement (1989), including among others:

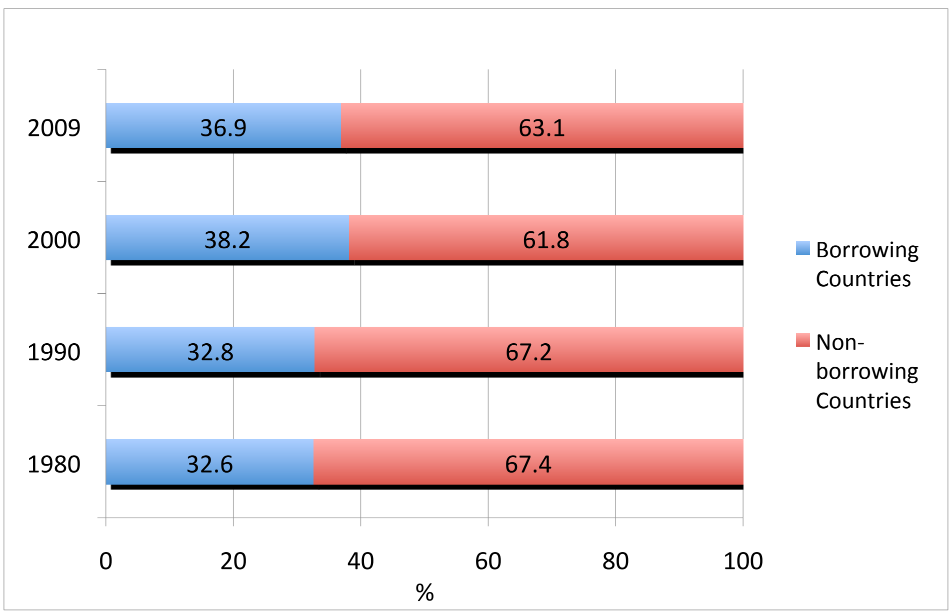
- Any amendments to the Articles of Agreement require 85% of voting shares (Art. VIII (a)).
- Increasing the number of EDs requires 80% of voting shares (Art. V, Section 4(b))
- An increase in capital requires 75% of voting shares (Art. II, Section 2(b))

These specific situations reveal which areas are of most concern to the major shareholders, most notably the U.S. For example, the provision on reforming the Articles of Agreement was originally 80% of voting power, but during the 1989 General Capital Increase the U.S.'s share would fall below 20%, and as a condition of the U.S. agreeing to the capital increase, the Articles were modified to ensure the U.S. retains an effective veto (Kapur et al. 1997). Likewise, while the U.S. cannot by itself block changes to the number of EDs or the IBRD's capital, it must only find one or two allies among major shareholders to do so. Further, the U.S. has up to now had the "unwritten" right of appointing the president of the World Bank (while European nations get to name the head of the IMF). While the president does not vote in board meetings, he (or she) does have very significant power to shape the World Bank's agenda, policies and operations, and to control what is or is not presented to the board.

[5] The correspondence is not entirely exact, however. For example in 2009, the U.S. contributed 17.4% of paid-in capital, 16.8% of callable capital, and had 16.36% of voting power.

The number of chairs for the Board of Executive Directors is another way in which developed countries magnify their influence. On the 24-member board, only eight countries currently have their own chair on the board: the five largest shareholders (US, UK, France, Germany and Japan), as well as Russia, Saudi Arabia, and China. All other chairs represent groups of countries, which must elect their ED and every two years. In practice, the ED generally comes from the wealthiest country in the group, or is alternated between the two wealthiest countries. These frequently turn out to be non-borrowing countries, which end up supposedly representing the interests of a large group of borrowing countries. By mixing the two types of countries together in a single chair, borrowers have an even more complicated task to exercise what little formal power they have.

Figure 1.2. IBRD Voting Shares, 1980-2009



Source: World Bank Annual Report 2009, 2000, 1990 and 1980.

IBRD EDs also serve as the EDs for the other main components of the World Bank Group—IDA, IFC and MIGA—although their voting power is not the same in each organization. The focus of this thesis is mainly on the interaction between MDBs and client country governments in development operations, hence IFC (the World Bank Group's private sector lending division) and MIGA (an agency that offers guarantees to private investors) are not discussed here. Nor is the IDA a main focus of analysis. IDA countries by definition have a very high level of financial needs, meaning their demand for MDB loans is generally unchanged (hence it is not relevant for Hypothesis 2). As well, IDA is not designed to be financially self-sustaining as the IBRD, but is funded with regular contributions from non-borrowers and the IBRD itself (hence it is not relevant for Hypothesis 3). Nonetheless, it is worth noting that countries with no eligibility to borrow from either IBRD or IDA have a total of 59.6% of voting power in IDA, compared to 40.4 percent for all borrowers.

In summary, it is evident that the IBRD and IDA are thoroughly controlled by non-borrowing countries. Even on issues requiring only a simple majority, borrowers would have to organize an entirely unified front, and then convince at least one or two major donors to side with them to achieve 50% of the votes. And even this complicated task is made more difficult by the fact that in the Board of Executive Directors, where most decisions only requiring a majority are taken, borrowing countries are invariable "represented" by EDs elected by a group of both borrowing and non-borrowing countries. And on major issues decided by the Board of Governors, special majority rules make it harder still for borrowing countries to outvote non-borrowers. Hence, the World Bank is clearly controlled by non-borrowing countries.

1.4.2 IADB

The organizational structure of the IADB is very similar to the World Bank—which is no surprise, as the IADB was the second MDB in existence and the World Bank was the only model to copy. As well, the IADB was created largely under the direction of the U.S. government, which viewed the World Bank's structure as a useful one for exercising its interests. Here again, high-level decisions are made by the Board of Governors at its annual meeting, while day-to-day decisions on projects and policy are delegated to the Board of Executive Directors that sits in continuous session at the IADB headquarters. The only organizational difference of note (and a minimal note, at that) is that the policies and projects of the concessional and non-concessional lending windows of the IADB are governed by the same board, rather than separate ones with separate voting power, as at the World Bank. And like the World Bank, voting power allotted as a function of financial contribution to the IADB's capital base.[6]

The distribution of voting power among shareholders is quite different at the IADB, however. While the U.S. has always been the largest shareholder, borrowing countries have always had a combined voting power of more than 50% in the IADB (Figure 1.3). This share was considerably higher when the IADB was first created in the 1960s, but began to be diluted in the 1970s when new non-borrowing members were admitted for financial reasons, as discussed in Chapter 2. To ensure that new members did not threaten the power of regional member countries, the Articles of Agreement (Article VIII, Section 4 (b)) were modified as part of the negotiations of the 8th general capital increase (1995) to state that the voting share of regional borrowing members would not fall below 50.005% and the U.S. share would not fall below 30%.

For most policy and project decisions, a simple majority on the Board of Executive Directors is required—giving borrowing countries controlling power, if they act together. Non-borrowing countries could likely pressure at least one borrower to side with them in an important vote, because of the wafer-thin majority. However this absolute majority has evidently proved significant in the past, as one example reveals. In the mid-1980s, the U.S. Reagan administration perceived the IADB to not be sufficiently compliant to U.S. interests, and held up the 7th capital increase for three years, insisting that it be given veto power in the Board of Executive Directors. Borrowing members, backed by IADB President Ortiz Mena, refused, and as a result the IADB's lending dropped precipitously. Finally an agreement was reached in 1989, wherein the voting rules stayed intact, but individual EDs were given authority to delay certain projects (see Tussie, 1995). The fact that both sides were willing to bring the IADB to the brink of financial collapse, especially during the height of the Latin American debt crisis, testifies to the importance of the borrowers' majority on the board.

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[6] As with the World Bank, the correspondence is not exact. For example, the U.S. had 30.006% voting share, but 30.03% paid-in capital and 28.82% of callable capital.

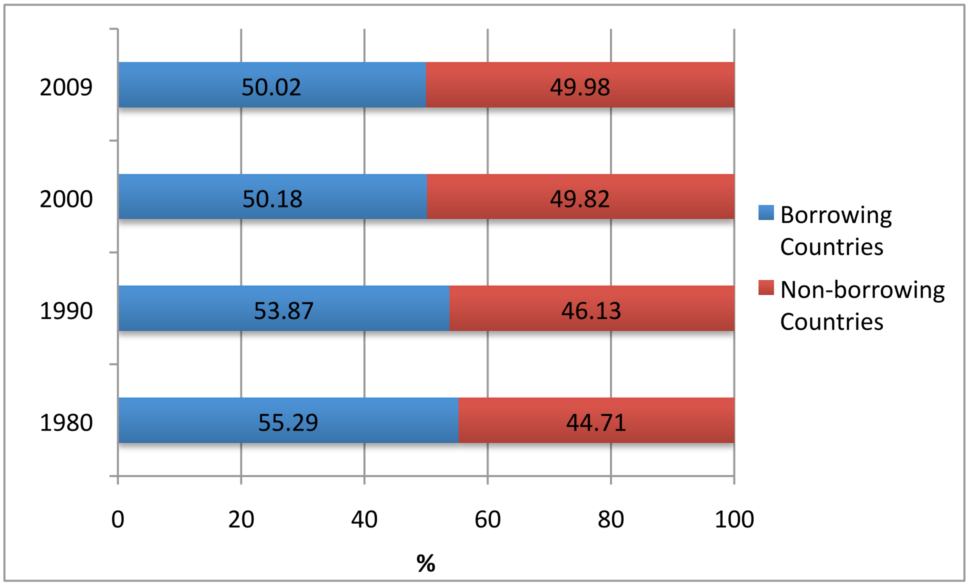
Despite the relatively high weight of borrowers on the IADB in most policy and project decisions, non-borrowing shareholders—most especially the US—have several other ways to exercise their power. The Articles of Agreement (1996) call for special majorities on many more issues and at a greater level of detail than in the World Bank, and in each case the U.S. is given veto power by requiring a 75% majority of votes. The U.S. has full veto power over the same three issues listed above for the IBRD, as well as, among others, the following decisions that for the IBRD require only a simple or at most 2/3 majority:

- Admission of new non-regional members (Art. II, Section 1 (b))
- Changes in commissions charged on non-concessional IADB loans (Art. III, Section 12)
- Decisions on investments (Art. VII, Section 1 (iii))
- Decisions on allocating annual net income (Art. VII, Section 4 (a))
- Approval of every FSO (concessional) lending operation (Art. IV, Section 9 (b))
- Establishing a quorum in the Board of Governors (Art. VIII, Section 2 (e))

The U.S. is also widely considered to have informal veto power on the choice of IADB presidents, which it reportedly used to force through the election of the current president over the objections of many regional members (see Bank Information Center, 2010). Further, the number 2 official has "by tradition" been chosen by the US, and has always been an American citizen (sometimes one who speaks no Spanish and has no background in the region).

The IADB thus offers considerably more formal voting power to borrowing country shareholders than the World Bank, most notably a bare majority on the boards of governors and executive directors. At the same time, non-borrowers—mainly the US—have ensured veto power over numerous important issues in the governance of the IADB, at a far greater level of detail than at the World Bank. Thus more balanced arrangement, though still with veto power by non-borrowers over key issues, means the IADB is in an intermediate governance position compared to the other two MDBs.

Figure 1.3. IADB Voting Shares, 1980-2009



Source: IADB Annual Reports 2009, 2000, 1990, 1980.

1.4.3 CAF

The basic organizational structure of the CAF appears on the face of it to be quite similar to the other two MDBs described above. It is also governed in the final instance by an Assembly of Shareholders (equivalent to the Board of Governors of the World Bank and IADB), which in turn delegates a large share of oversight responsibilities to the Board of Directors. Country shareholders are represented on these two bodies through the ownership of capital shares. But these broad similarities hide a number of fundamental differences, both in organization and shareholder structure.

The most important and obvious differences are, first, that the CAF is now and has always been governed almost entirely by the countries that it lends to, and second, that it is considerably more egalitarian in its governance. It was originally created in 1970 by the six[7] nations of the Andean region, which were the same countries that the CAF lent to, and it functioned thus for 20 years. A unique two-tier shareholding structure was created that both allowed for different countries to contribute capital in accord with their economic weight, and at the same time ensured that this unequal economic weight did not

[7] Chile was a founding member, but withdrew in 1977 under the Pinochet regime. It has since returned as a minority shareholder.

translate into unequal representation in the CAF's governance. In the framework of Koenig-Archibugi's (2002) typology of global governance arrangements, this results in an MDB with very similar "publicness" and "delegation" attributes to the World Bank and IADB, but dramatically different "inclusiveness"—the CAF is and has always been much more egalitarian in its decision-making structure than the other two MDBs.

Each of the five member countries purchased an "A" share, at a cost of US$1.2 million.[8] The bulk of the CAF's capital was made up of "B" shares, which were distributed equally among Colombia, Peru and Venezuela. However, Ecuador and Bolivia purchased only about 1/3 as many "B" shares, in recognition of their much smaller economies. The Constituent Agreement has always stipulated that each A share has the right to designate its own representative on the Board of Directors (one each), while B shares vote to elect representatives in proportion to their financial contribution. Voting rules have always mandated that A shares have considerably more weight than B shares in all voting in both the Shareholder Assembly and the Board of Directors of the CAF, thus giving Bolivia and Ecuador more voice and vote than their financial contribution—in sharp contrast to the arrangements of the IADB and World Bank. The exact voting rules have varied over the years, the details of which need not concern us here. In all cases, A shareholders have had a proportionately larger voting power than B shares. Importantly, this has included unanimous approval of A shareholders to modify the Constituent Agreement.

CAF shareholding began to widen in the early 1990s, in the interests of diversifying both the CAF's source of funds and clients (as discussed in Chapters 2 and 4). Mexico was the first non-regional country to associate with the CAF in 1991, and by 2010 a total of 13 non-regional countries had entered into association with the CAF.[9] Until 2009, all new members were incorporated as "C" shareholders, which were permitted a capital share and voting power much lower than the A/B shareholders. These shareholders voted in Assemblies according to their financial contribution, and were not permitted to purchase

[8] Each A share originally cost US$1 million, but Chile's share was divided equally among the five remaining shareholders when that country withdrew.
[9] Argentina, Brazil, Chile, Costa Rica, Dominican Republic, Jamaica, Mexico, Panama, Paraguay, Portugal, Spain, Trinidad and Tobago and Uruguay. Both Italy and Guatemala had signed letters of intent by mid-2010, but had still not joined as of November, 2012.

either A or B shares—thus keeping their influence to a minimum. For all major decisions, the CAF General Regulations stipulate that the votes of at least four A shareholders continues to be required (CAF, 2008, Chapter III, Articles 15, 16 and 17). On the Board of Directors, C shareholders could jointly elect two out of 13 directors (Chapter IV, Articles 23 and 24), while five are appointed by A shareholders and five elected by B shareholders. The 13th director is elected by a group of private banks that are also B shareholders since 1989.

In 2005, shareholders approved a reform to permit any country within Latin America and the Caribbean to become an A shareholder (Chapter X, Article 59). In 2010, Brazil, Panama, and Uruguay had done so—for the first time expanding the CAF's full membership beyond the Andean region. These countries have full A shares and thus voting power equal to the original members. Argentina followed in 2011. The CAF has also begun expanding C shareholders beyond the Latin American region, for the obvious purpose of shoring up its capital. Spain purchased C shares in 2002, and now accounts for over half of the CAF's guaranteed capital (though a much smaller portion of paid-in capital). Portugal purchased a small number of C shares in late 2009, and again contributed a much larger share of guarantee capital. Italy has reportedly signed a letter of intent to purchase C shares in the future. As of 2011, only Spain was represented on the Board with 3.1% voting power, sharing representation with Trinidad and Tobago. Notably, non-Latin American countries—the only non-borrowers associated with the CAF—are not eligible to purchase A/B shares. In a 2009 magazine interview, CAF President Enrique García stated that developed countries would never be allowed to have more than 15% of shareholding power (O'Shaughnessy, 2009). This policy is not in the Constituent Agreement or CAF regulations, but is evidently an unwritten rule followed by the organization's shareholders when considering new members.

Thus, the CAF's shareholding structure serves to attract the capital needed for the MDB's growth while at the same time providing greater equity in voice and vote among shareholders of differing economic strength, compared to other MDBs. A further point in this regard is that the president of the CAF has always been a national of either Bolivia or

Ecuador, the two nations with the smallest share of the CAF's capital. Non-borrowing members are permitted only on a very limited basis, clearly (from the CAF's point of view) mainly for the usefulness of their guaranteed capital, which could be considered stronger than that of borrowing members with lower bond ratings.

Aspects of the CAF's governance structure are also notably different from the World Bank and IADB. While the Shareholder Assembly meets normally once a year, as with the Board of Governors of the other two MDBs, the Board of Directors meets only when called on for special purposes, rather than sitting in permanent session. Instead, the vast majority of policy and lending decisions are taken by an Executive Committee presided over by the CAF's executive president (Chapter IV, Article 27 (h)), and are then approved with minimal fuss by the Board during twice or thrice annual meetings. As described in Chapter 5, this organizational structure is much more streamlined than either the IADB or World Bank, and gives considerably more autonomy to the CAF's administration vis a vis its shareholders.

2 Financial Pressures and Organizational Convergence in Multilateral Development Banks

As will be seen in subsequent chapters, shareholding arrangements embed a series of characteristics that make each multilateral development bank (MDB) more or less attractive from the point of view of borrowing countries, when those borrowing countries are in a position to choose. Before moving on to that analysis, however, it is instructive to examine how MDBs arrived at their operational model, and how shareholder interest and financial pressures played a role in that process. The chapter seeks to understand how the combined influences of shareholder interest and the realities of securing the resources needed to operate pushed each of the three MDBs to move toward similar organizational structure and policies, despite the intentions of the founders. Thus, the chapter will gather evidence related to Hypothesis 1 (the role of shareholder interest) and Hypothesis 3 (the role of financial imperatives).

Broadly speaking, the evidence indicates that shareholder interests did indeed play an important role in establishing the initial goals of each MDB and in strongly shaping the strategies used to secure the necessary funding to undertake their mission. However, it also points to the fact that financial imperatives in many cases undermined the original intentions of founders, necessitating each MDB to move in unexpected directions as a result of pressures exerted by the need to obtain resources with which to operate. In a sense, this chapter tells a story of convergence toward a single financial model for MDBs, one that has been replicated at least 20 times around the world and which continues to be attractive today.[10] Once that model was established, and especially during times when demand-side considerations are more relevant to borrowing countries, greater divergences within this model become more apparent, a phenomenon to be analyzed in later chapters.

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[10] For one example, the recently created European Financial Stability Facility raises money by issuing bonds on private markets, based on a guarantee commitment by member nations. See EFSF, 2012.

The research finds that the tensions between the original development goals of the founders and the realities of running a sustainable financial institution in each case led to far-reaching changes in MDB operations. This, in turn, was strongly conditioned by the relative power of the countries backing each MDB—their own interests as well as the perception of other countries and private markets toward them. What is more, the changes in each MDB all moved in a similar direction, converging on a model of MDB activity much more similar to one another than their founders had planned. Essentially, the model relied much more on accessing funds from private bond buyers than originally intended, and with that came a number of exigencies to keep the capital markets buying their bonds at rates low enough to be able to on-lend to developing countries at attractive rates, with enough of a margin to cover administrative costs and make the entire model function. Thus, if one presupposes: i) the limited willingness of governments to provide budgetary resources to MDBs and ii) a built-in desire for organizational survival, then there seems to be almost an "ideal type" of MDB, toward which all will tend to evolve.

This chapter does not provide a general history of the MDBs. Rather, the focus is on: (i) how the interests and relative power of the countries behind them led to their respective strategies of mobilizing resources; and (ii) how that in turn directly impacted their operations. The periods to be examined are the World Bank 1947-1963, the IADB 1960-1975 and the CAF 1970-1993. While the time frames vary somewhat, in each case this encompasses the early phase of organizational life cycle: conception, birth and adolescence. Each case concludes with a turning point that deeply shaped the MDBs we see today—their "mature" form.

The analysis is based on primary documents—mainly annual reports, proceedings from board of governor meetings, speeches of key officials and journalistic accounts, supplemented with secondary sources. In the case of the World Bank, secondary sources are relatively more important, as it has been the topic of considerable scholarly research. The IADB is the subject of a much smaller body of research, and most material in that section is based on primary sources and some journalistic accounts. In the case of the

CAF, secondary sources are minimal and the proceedings of board meetings are not publicly available.[11] Hence that section is derived mainly from speeches of CAF presidents, annual reports, documents from the Andean Community and some journalistic accounts.

2.1 The World Bank: From New Deal to Wall Street and Part Way Back Again[12]

The idea of a multilateral development bank began at least as early as 1890, when a number of Latin American countries pushed for the creation of a specialized bank to facilitate capital flows to the region (U.S. Department of State, 1940; see also Helleiner, 2006 and 2009 for a thorough analysis of this episode and its implications for the evolution of "development" in the post-World War II era). The U.S. expressed support for the concept—driven in part, as Helleiner (2006) notes, due to concerns of growing influence by the Nazis and the trend toward more radical statist economic policies in the region—but despite repeated requests by the Latin Americans no action was taken until 1939, when a conference was held in Washington to hammer out a concrete plan. The proposed bank called for member governments to contribute half of their capital share in cash and half as a guarantee, with voting rights apportioned according to the level of contributions. The exact origins of this form of organization, with shareholder contributions and proportional voting power, are not entirely clear (and would be an interesting topic to investigate), but it obviously arises out of corporate governance practices. The new bank was to make short- and long-term loans, function as a clearinghouse for international payments, assist in currency stabilization, accept deposits, and much else besides (Ibid.). This grandiose design led to considerable opposition among the financial community and in Congress, which was sufficient to ensure no further action (see Helleiner, 2006, p. 955).

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[11] The author has contacted the public affairs office of the CAF, which supplied scans of all annual reports not available on the Internet (dating back to the CAF's inception) as well as several collections of speeches and official histories that are not otherwise available. However they specified (and this was later confirmed in interviews with higher-level staff) that board proceedings are not made public under any circumstances.

[12] The research on the World Bank in this chapter relies heavily on Mason and Asher, 1973, and Kapur et al., 1997. In many instances, I have returned to their original sources, notably in the case of the World Bank Oral Histories (WBOH), to verify and seek further information.

In 1942, a U.S. Treasury team under the leadership Harry Dexter White, who had worked intensively on the earlier inter-American proposal, took up the ideas again with a view to planning the post-war economic order. Cognizant of the opposition that arose from one all-purpose institution, White proposed instead to create a fund for monetary issues (which became the IMF) and a separate "International Reconstruction Bank" to facilitate credit flows for reconstruction after the war.[13] White's proposed mechanism was emphatic about facilitating private lending, while direct lending was to be secondary (Mason and Asher, 1973). Similar to the inter-American proposal, all member countries would pay in a determined amount of cash and gold (20%), and would guarantee the remaining capital subscription to be called on if necessary to meet the bank's obligations. Total capital was set at US$10 billion. The bank would be governed by government shareholders with voting power directly proportional to their contributions—just as a private corporation. Perhaps not coincidentally, this scheme afforded the U.S. a dominant voice in controlling policy.

There is no record of any opposition to this arrangement at Bretton Woods, where most of the debate focused on the design of the IMF. In fact, the US's original plan called for no member to have more than 25% of voting power, but because several countries wanted to limit the size of their subscription, the U.S. raised its subscription to make up the shortfall and ended up with 37% of voting shares (Bittermann, 1971). The main discussions about the bank at Bretton Woods were of emphasis. European participants wanted the bank to specifically focus on reconstruction, and they favored the use of loan guarantees. Less developed countries—led by Latin America—instead wanted the bank to highlight its development role, and to make greater use of direct loans, since many would have had to pay higher rates even with guarantees (Kapur et al., 1997 and Helleiner, 2006). The U.S. facilitated compromises to include a balance of both positions in the final agreement.

[13] See Helleiner, 2006 and 2009 for a thorough analysis of how the creators of the World Bank envisioned its role as a development promoter.

Because the UK was facing serious balance of payments problems, the UK delegation—led by John Maynard Keynes—insisted that the member currency portion of paid-in capital would only be used for lending with the explicit consent of the country (Bittermann, 1971). This meant that when the bank eventually opened for business, its resources were extremely limited,[14] and would be forced to raise capital on private markets much faster than it might have otherwise. Thus, right away the tension between the ideas of founding governments and their willingness to actually contribute usable resources pushed the new bank in unexpected directions.

2.1.1 Wall Street Moves In

The Truman administration—still under the influence of Roosevelt's New Deal ethos—viewed the newly created International Bank for Reconstruction and Development (IBRD)[15] primarily as a tool of government, not Wall Street. This was manifested in locating it in Washington DC, over the objections of several European countries, who favored New York. As Treasury Secretary Fred Vinson wrote at the time, referring to the World Bank and IMF, "It must be remembered that these are not ordinary institutions with ordinary stockholders. They are cooperative enterprises of governments and their chief business is with governments…They should not become just two more financial institutions" (1946, p. 626). The U.S. intended to keep a tight reign over the Bank's administrators by making them subservient to a board of executive directors representing member countries, which would sit in permanent session and vote on all decisions. Again, Vinson explained the logic: "If final authority is vested in the administrative officials, the Executive Directors become little more than an advisory body. In my opinion, this would be contrary to the manner in which it was intended to operate the Fund and the Bank" (Ibid., p. 627).

Being subjected to the changing whims of politicians, however, did not suit the early leaders of the World Bank, who were recruited from Wall Street and saw their independence from politics as essential to gain market confidence. John J. McCloy, a

[14] Essentially it was limited to the U.S. portion of paid-in capital, and the 2% each member was required to pay in gold (the rest being in non-convertible local currency).
[15] This is still the formal name for the main lending window of the World Bank.

lawyer with strong connections to the New York financial community, was persuaded to accept the job in late 1946.[16] Before doing so, McCloy set as his conditions that the board make a clear statement ensuring that management would be allowed a generally free hand in running operations, and the board would confine itself to a supervisory role. The board agreed, and McCloy took the post.[17] McCloy brought with him Robert Garner to serve as his vice-president, a hard-nosed New York banker, and U.S. executive director Eugene Black, former vice-president of Chase National Bank of New York. Thus right at the start of its operations, in the interests of establishing a "serious" financial institution free from political meddling, McCloy ensured a far greater degree of staff autonomy from the executive directors than originally envisioned at Bretton Woods, a balance of power that continues to the present day. As The Economist magazine noted with satisfaction at the time, "From the Bank the first President and the first U.S. Executive Director have gone, and been replaced by nominees of Wall Street" (1947a, p. 638).

As noted above, it was generally assumed at Bretton Woods that the IBRD would primarily offer guarantees for governments borrowing from private sources. However, it soon became clear that guarantees would not be feasible, for several reasons. In the first place, New York investors themselves were unenthusiastic about guarantees (Mason and Asher, 1973). As well, IBRD staff quickly realized that even with a guarantee, many countries would still be paying considerably more for money then if the IBRD borrowed itself and lent it on, which didn't make sense. A further consideration was that the regardless of the guarantee, the markets would offer differing interest rates to different clients, which the IBRD feared could impact its own credit rating. As Eugene Black commented later, the IBRD backed away from guarantees because "If we had too many of these things [guarantees] kicking around, it would be harmful to the establishment of the market for World Bank bonds themselves" (WBOH, 1961b, p. 22).

[16] The first IBRD president was Eugene Meyer, who resigned after only a few months on the job due to battles with the executive directors.

[17] Robert Garner recalled that during the negotiations, McCloy told the board that "if the directors were not fully in agreement with that, we would go on back to New York that afternoon. Then the directors went into executive session and after lunch they said they were fully agreeable. So the deal was made." WBOH, 1961a, p. 4.

But if the Bank would be making loans rather than guarantees, it faced a serious shortage of capital. The only lendable resources available to the IBRD at its launch were the U.S. paid-in capital and the 2% paid in gold by other members—a total of US$727 million. While that was a considerable sum, it paled in comparison to the reconstruction needs of post-war Europe. Just the first two loan applications alone, from France and Netherlands, totaled US$1.035 billion. As a result, turning to the markets was a clear necessity right from the start. The Economist highlighted this reality in May 1947: "The French loan alone obviously earmarks a substantial portion of the total stock of dollars. Hence the Bank must soon determine its ability to obtain more dollars, which of course can only be done by borrowing in the American market…Consequently, extensive explorations are under way with the market" (1947b, p. 760).

Private financial markets, however, had every reason to be wary of lending to this unknown financial creature. Not only was it new, but it was specifically designed to lend to foreign countries, many of them poor and with a long history of defaults—hardly a business model to gain Wall Street's trust. Thus the initial forays of IBRD staff to New York were not a resounding success. Recounting his first trip to meet investment bankers in New York, Richard Demuth said, "There was an amazing discrepancy between the attitude of the bankers and the expectations of Bretton Woods …In general, it was thought of as a do-good institution, as a wild idea, without any respectable support" (WBOH, 1961c, p. 10-11).

The intensive preparatory work of the IBRD leadership, as well as their personal contacts and good reputation on Wall Street, paid off when the IBRD's first two bonds were publicly issued on July 15, 1947. Totaling US$250 million—the exact amount of the IBRD's first loan, just issued to France—the bonds were rated as investment grade by Standard & Poors and Fitch, and were oversubscribed by noon of that day (Mason and Asher, 1973). Despite this success, future prospects for regular bond issues were far from certain. The following year, an article in The Economist noted that "Since its [the IBRD's] dollar resources cannot be allowed to run down completely, the remaining scope for dollar loans is modest and will remain so unless Wall Street can be induced to absorb another issue of the IBRD's bonds. There is very little prospect of this at the moment" (1948, p. 502). The IBRD would not issue again in the New York market until 1950. Establishing a regular presence as a borrower would take more than good marketing—it would require demonstrating that the IBRD would operate in a way that made it a safe investment. This, in turn, would fundamentally shape the IBRD's lending.

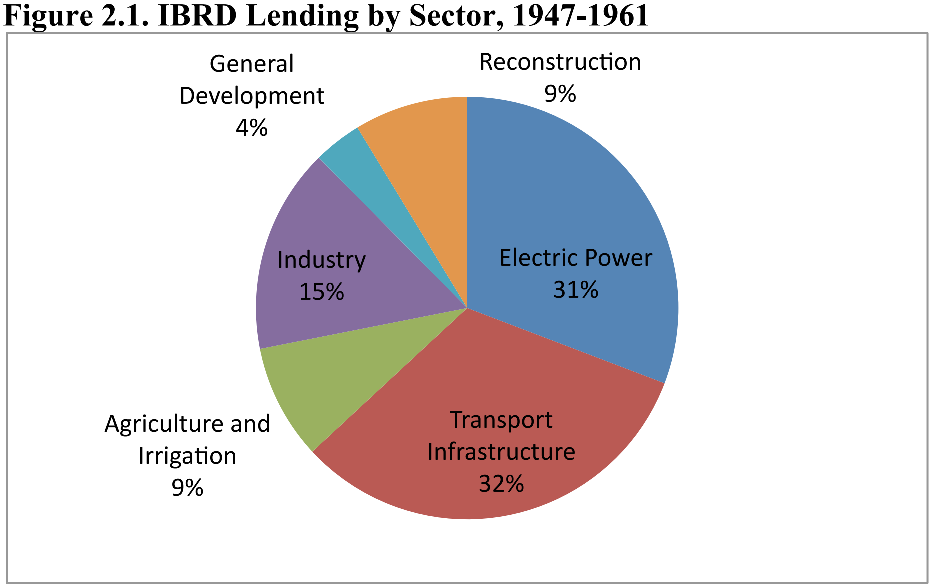
2.1.2 Wall Street Concerns Shape Early Operating Policies

McCloy's team made no bones at all about the principles that guided the early lending operations of the IBRD. In presenting the second annual report to the Board of Directors in September 1947, McCloy stated that "the Bank must attach importance to the views of the American investor and must conduct its activities in such a fashion that its bonds will be considered a sound business risk by the United States financial community" (Mason and Asher, 1973, p. 54). A few years later Garner—who was in charge of operations at the time—stated that "The Bank must convince the private investors who buy its bonds that it is operating on sound banking principles. Otherwise, we might be cut off from one of our main sources of funds for lending" (World Bank, 1952).

In the three years between Bretton Woods and the IBRD's first loan to France in May 1947, U.S. policymakers drew up the Marshall Plan for European reconstruction. This removed what had been the IBRD's primary purpose—post-war reconstruction—and also removed what would have been its most creditworthy borrowers. Thus the IBRD was quickly pushed into the unknown territory of "development." Between August 1947 and the end of 1949, the IBRD made only three loans, two to Chile for US$28 million and one to the Netherlands for US$12 million. This was driven by the inability to raise more money on the market, and also by the desire to establish exacting technical standards for loan approval that would be seen as prudent by potential bond investors. "We had then to show that we were going to make some sound loans, that we were not going to give the money away. Until we did that and until we acquainted people with what the other safeguards were, the Bank had no credit," said Black, reflecting on this period (WBOH, 1961b, p. 7).

A key aspect of how the IBRD established and guarded its credit standing with the markets was the kind of loans it made. The Articles of Agreement call for lending only for "specific projects", although (with characteristic vagueness) this could be bypassed in "special circumstances." The specific project ethos became an obsession with the early IBRD.[18] One of the great advantages of the specific project, as one early staffer openly admitted, was that it looked good to the markets. "The market likes the idea of specific projects," said one. "There's a feeling that if you know exactly where the money goes, it must be a sound thing" (WBOH, 1961d, p. 41). The IBRD strongly emphasized only projects that would generate income, and hence increase its chances of getting repaid. This meant physical infrastructure with direct impacts on economic production. "I think that if we got into the social field in the Bank then the bond market would definitely feel that we were not acting prudently from a financial standpoint," said one early staffer forthrightly. "If you start financing schools and hospitals and water works, and so forth, these things don't normally and directly increase the ability of a country to repay a borrowing" (WBOH, 1961e, p. 63-4). This led to a very heavy emphasis on electric power, transportation infrastructure and large-scale irrigation works, which were seen as sound, bankable projects (Figure 2.1).

Figure 2.1. IBRD Lending by Sector, 1947-1961



Source: World Bank annual reports 1947-1961.

[18] This is despite the fact that the almost complete fungibility of money in a borrowing government's accounts made the "specific project" a myth. See, for example, Feyzioglu et al., 1998.

Hand in hand with the specific project lending style, the IBRD also evolved an extremely rigorous and intrusive system of resource disbursement. In choosing which countries to lend to, the issue of need or income level played a minimal role, while a country's perceived credit risk was a major factor. "The general idea was quite clear even at that early stage that the Bank could lend only if it were satisfied that it could get its money back. Therefore, a study of the economy of the country was pretty fundamental," said an early staffer (WBOH, 1961d, p. 5). Thus, the IBRD's extreme intrusiveness began right from the start, specifically to reassure its bond buyers that it was keeping a close eye on their resources. As a result, lending was slanted heavily toward more creditworthy borrowers, rather than poorer countries. Out of US$5.7 billion in IBRD loan commitments between 1947 and 1961, US$2.6 billion (45%) went to Europe or Australia and a further US$1.4 billion (25%) to larger and more advanced developing countries,[19] while only US$1.7 billion (30%) was dedicated to poorer developing countries.[20]

2.1.3 An Embarrassment of Riches and the Birth of IDA

As a result of the operational policies described above, the IBRD reputation as a "sound" financial institution grew. The spread between IBRD and U.S. government bonds of similar maturities fell from 0.74% in 1947 to 0.25% in 1952 (Mason and Asher, 1973), and the IBRD began accessing capital markets outside of the U.S. to reduce dependence on the U.S. market (WBOH, 1961b). However, the IBRD's increasingly solid financial situation and excellent reputation in the credit markets had no impact on the tough conditions for borrowers. As early as 1950, even The Economist was calling for it to relax: "Recent experience has shown that its rigid approach and conditions of lending (for which there is something to be said on other grounds) do not provide a flexible means of handling the infinite variety of projects that must emerge from any programme for the opening up of under-developed countries. It resembles commercial banks in the United

[19] This includes: Argentina, Brazil, Chile, Colombia, Costa Rica, Iran, Israel, Mexico, South Africa and Uruguay.
[20] This includes: Burma, Ceylon, Ecuador, Egypt, El Salvador, Ethiopia, Guatemala, Haiti, Honduras, India, Iraq, Lebanon, Nicaragua, Pakistan, Panama, Paraguay, Peru, Philippines, Sudan, and Thailand. Of this, nearly US$1 billion went to Pakistan and India, an area of key geopolitical interest to the United States and the United Kingdom, the IBRD's two most powerful shareholders.

States in that it is too intent on the collateral or security aspect of any operation" (1950, p. 546).

But Black and Garner, true believers in the virtues of market discipline, fended off calls for change, invariably pointing to the fickle opinion of the all-important bond market. There was some justification for this position in light of the IBRD's long-running battle to be granted the coveted AAA rating by the ratings agencies, which was finally granted in 1959. Other evidence, however, suggests that while the IBRD's operating style may have been a necessity to access resources in the first years, it had simply become ingrained behavior by the end of the 1950s. One high-level staffer noted that by 1961, bond holders no longer "scrutinize the day-to-day lending operations the way they used to," adding that if the IBRD wanted to start lending for things like water distribution, "I don't think these things would have the slightest affect on its credit" (WBOH, 1961f, p. 65). But the caution and preoccupation with bond buyers had planted deep roots in the IBRD's organizational culture.

By the end of the 1950s the IBRD's financial strength was remarkable, with net income increasing each year and reserves growing from US$4 million in 1948 to US$288 million in 1964. As a result, the IBRD faced rising criticism to ease the terms of its loans and to ramp up lending to address development concerns. These issues—along with an evolving external geopolitical environment—would come together in the late 1950s and early 1960s in a way that would lead to major changes in the IBRD's structure. Since the late 1940s, the United Nations had called for greater lending volumes to developing countries at easier terms than offered by the IBRD. A 1951 report, calling for billions more to be lent annually for development, states that "In view of the need of under-developed countries for capital, the Bank cannot be said to be meeting the challenge of the circumstances…The Bank has not adequately realized that it is an agency charged by the United Nations with the duty of promoting economic development" (UN, 1951, p. 82-3). The report then goes on to propose the creation of an International Development Authority in the UN for the express purpose of overcoming the many limitations of the IBRD.

As could be expected, the IBRD vigorously fought the proposal, and because of its financial autonomy, the UN could do little to change its policies. As one IBRD staffer charged at the time with negotiating with the UN put it laconically: “They [the UN] are the central global body, and they feel they ought to be able to exercise authority over all the other international agencies. On the other hand, the Bank has the money” (WBOH, 1961c, p. 20). But by the late 1950s, the panorama had changed considerably. The Eisenhower administration—faced with the movement of the Cold War to “Third World” countries in Africa, Latin America and Asia—began to come around to the view that more resources were needed to help fight the communist threat than the IBRD could provide. However, the U.S. insisted that the new lending body be housed at the IBRD, rather than the UN, for the obvious reason that it had veto power at the IBRD because of its governance structure proportionate to shares rather than one country, one vote as in the UN. Most developing countries naturally objected, but since the U.S. would be putting up most of the funding, they could do little about it.

The IBRD leadership had by this time resigned itself to the inevitability of what would come to be called the International Development Association (IDA), but staff ensured that it would be implemented in such a way that it would not negatively impact the IBRD’s credit. One key point was that while IDA would be run by the IBRD, it would have completely separate financial accounts. The point, according to a high-level staffer at the time, was “to emphasize to the world, especially to the investors in IBRD bonds, the completely different financial status of the two institutions… This was to, as I say, assure investors in Bank bonds that their interest in the Bank would not be diluted by the diversion of funds into the softer IDA channels” (WBOH, 1961g, p. 34). In reality, this was (and remains) an elaborate fiction, since from the start the same staff worked on both IBRD and IDA loans in all countries around the world.

IBRD staff soon saw that IDA had its uses. For a start, it allowed the IBRD to offload many of its riskiest borrowers (notably India and Pakistan) to IDA, thus dramatically improving the quality of the IBRD’s portfolio. The IBRD’s share of high-risk loans fells sharply after IDA was created, from a peak of 27.3% in 1963 to 20% in 1967 and 15% in 1975, "presumably resulting from the introduction of IDA", commented an internal report (cited in Kapur et al., 1997, p. 933). Eugene Rotberg, a long-serving treasurer of the World Bank, described the importance of IDA to the Bank as follows: "It's more of a safety valve to permit economic and financial support to countries which are not credit-worthy but, if it were not available, would probably get some Bank lending at the margin and, in so doing, I believe jeopardize the financial credibility of the Bank" (WBOH, 1994, p. 31). Further, IDA provided a useful means for easing pressure on the allocation of IBRD net income. By 1964, reserves had grown so large that the IBRD feared the U.S. Congress would try to redirect it to the UN. Hence the IBRD began making allocations out of net income to IDA—thus keeping the resources "in house" due to the extensive overlap between IBRD and IDA operations.

2.1.4 Summarizing Findings

The first decade and a half of the World Bank clearly demonstrates the strong role played by the confluence of financial imperatives and the relative power of shareholders in shaping the world's pre-eminent development institution. The IBRD was originally founded as a New Deal-type organization, controlled by member governments and with fundamentally political aims. However, the model designed at Bretton Woods was quickly overturned. Because of its limited available resources and the need to make direct loans instead of guarantees, the IBRD had to turn to private capital market almost immediately to raise resources. To do so, the Wall Street-led leadership demanded and were granted management ascendency in controlling bank policy over the executive directors, who represented shareholder governments.

The advent of the Marshall Plan further relieved pressure on the IBRD from U.S. and European shareholders, giving it the breathing space needed to institute rigorous operational policies the new leaders saw as necessary explicitly to maintain the good graces of Wall Street. This included the "specific project" ethos that restricted lending to "profitable" projects, a focus on creditworthiness as opposed to country need to determine lending allocations, deep investigation and involvement with borrowing country macro-economic policy and a fixation with generating IBRD income and building up reserves. Whether or not the extreme focus on market perception by the early IBRD staff was justified or not is debatable. But unless the U.S. and other major shareholders would have been much more generous in their contributions early on, then the IBRD faced the choice of either turning to the markets or remaining insignificantly small. And if the IBRD was to access the markets on a regular basis, then logically it would be obliged to institute operational policies that ensured a track record of repayments and organizational finances sufficiently strong to win the approval of ratings agencies and investors who had little or no interest in the IBRD's development mission.

However, the IBRD was not simply a financial institution focused only on credit risk and the financial bottom line, despite the attitudes of Black, Garner and their team. It was (and is) a deeply political organization, and this became evident in the late 1950s. The growing awareness among wealthy nations of poverty in the rest of the world and the social tensions it could lead to, as well as the unhappiness with the IBRD's strict guidelines and limited capacity or willingness to lend more, led the U.S. and Europeans to support the creation of IDA. The advent of IDA began shifting the World Bank's operations more toward social aspects of development and poverty alleviation, rather than just heavy infrastructure. But the obsession with running the World Bank in a way that would please bond markets was by then deeply ingrained and would only change going forward at a very slow pace.

Thus the schizophrenic character of the World Bank—proclaiming its allegiance with the poor and emphasizing its social mission, while at the same time keeping a constant watchful eye on its financial bottom line—began to evolve. The specific dynamics of this schizophrenia were different in each subsequent MDB due to different shareholder composition as well as international circumstances, as shall be seen in the two cases below, but the basic underlying tension is found in all.

2.2 Inter-American Development Bank: Something New Under the Sun?

The creation of the Inter-American Development Bank (IADB) was in many ways a direct result of the conservative lending policies of the World Bank outlined above, coupled with the changing strategic views of the United States toward Latin America. Of the 38 countries that joined the IBRD at its creation in 1946, 16 were from Latin America (and three more joined the following year), suggesting that the region had considerable interest in the success of the new development bank and the expectation that it would be relevant to their region. These expectations were soon frustrated. Latin American countries were clamoring for large amounts of external capital to build up their domestic industries, but the IBRD could not (or would not) supply either the quantity or type of lending the region desired. In the 14 years between 1947 and 1961, the IBRD lent a total of US$1.3 billion to all of Latin America, and about half of that total went to only four countries, Brazil, Chile, Colombia and Mexico (World Bank, 1962). In line with the IBRD's concerns about funding specific projects that would generate returns, fully 90 percent of IBRD lending was for electric power and transportation, with the remainder for large-scale mechanized farm operations, mining and logging. Not a single loan was dedicated to state-run or private domestic industry—the main preoccupation of Latin American governments at the time—or for any social projects such as water supply, housing, or education (Ibid., 1962).

A series of conferences were organized by the Organization for American States (OAS) in the mid-1950s to address the region's external financing needs discussed creation a new regional development bank. Conference participants criticized the World Bank for lending too little, not lending to countries that did not follow determined economic policies or had past-due debts to the private sector, restricting loans to only a few types of projects, requiring excessive project preparation and charging too high an interest rate (Broide, 1961). By contrast, the proposed new bank would use "Latin American criteria" in offering loans (Ibid., p. 60, author's translation), and would support "certain operations that might not generate income to cover the financial service payments, but should be nonetheless granted as they are necessary to increase the productivity and quality of life of Latin American countries," such as sewage, housing and water supply (Ibid., p. 82, author's translation). However, without U.S. support the proposed bank would never access adequate financing, and the agreement was never ratified.

During the late 1950s, however, the US's views on the region began to shift from one of (relatively) benign neglect to concern over the potential for instability and threat to its global strategic interests. Trouble began brewing in Cuba, with a growing insurgency led by Fidel Castro threatening the pro-U.S. dictatorship of Batista. Vice-President Richard Nixon's disastrous tour of South America in early 1958, when he was greeted by angry mobs at all his stops and nearly assaulted in Caracas, brought home publicly the depths of antipathy felt toward the U.S. in the hemisphere. The Economist magazine directly linked these events with the U.S.'s change of heart about the proposed new bank: "This is a Latin American dream, regularly spurned as unrealistic by the United States until Vice-President Nixon's unfortunate experiences last year made the Administration realize that it might be a good thing to make a dream come true" (1959, p. 273). U.S. support for a regional development bank was announced in August 1958.

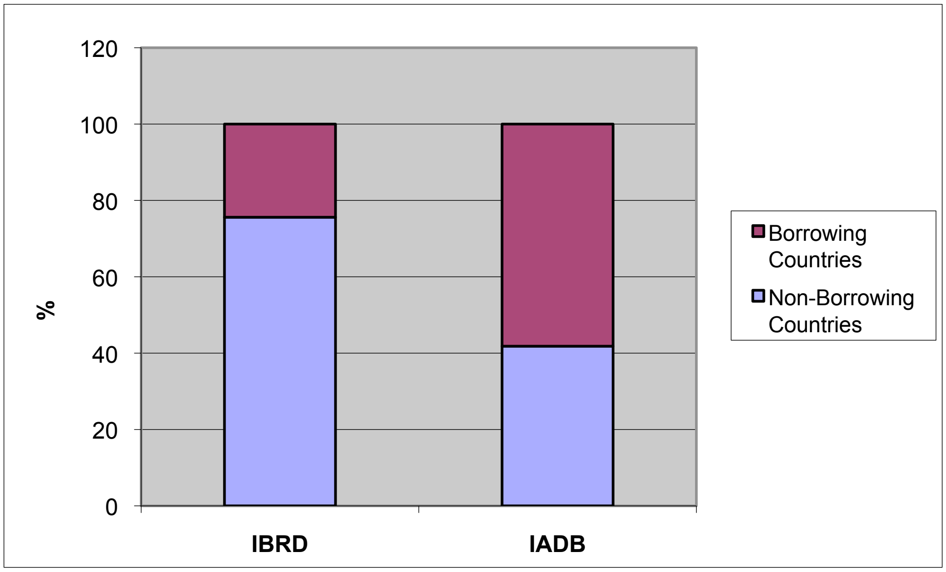
2.2.1 From Idea to Reality

Once the U.S. was on board, creation of the new bank moved ahead quickly, and it did so almost entirely on the terms dictated by the U.S. Unsurprisingly, the U.S. proposal hewed very closely to the model of the World Bank in terms of capital structure and overall operational policy. The new bank's shareholder governments (the U.S. and 18 regional countries) each contributed a share of capital, part of it paid in cash and the majority of it on call as a guarantee. As with the IBRD, operational policy was decided by the Board of Directors and final governance issues by the Board of Governors, both governed by shareholders in proportion to their share of capital. The lendable resources of the bank's Ordinary Capital (OC) would come from paid-in capital, the proceeds of previous loans and resources raised from private investors through bond sales or direct loans from governments. More creative techniques supported by some Latin American countries to endow the bank with greater resources—such as the ability to accept deposits and temporarily make use of Latin American central bank reserves—were rejected (Broide, 1961).

Within this broadly similar model, however, the U.S. proposed innovations to address the concerns of the Latin American countries. The most notable was the creation of a concessional lending window—the Fund for Special Operations (FSO)—as an integral part of the new bank, to provide low-interest financing for countries not able to pay market-based rates of the ordinary lending window, and for specific projects considered less "bankable". The IADB's charter also permitted more flexibility than the World Bank to make loans directly to private industry without requiring a government guarantee, also an important demand of Latin American countries intent on developing their domestic industrial base (IADB, 1996).

However, U.S. support came with a cost. Latin countries had a majority share on both the IADB's Board of Governors (which would meet once a year) and the Board of Directors (which sat permanently to oversee operations). Hence, in theory borrowing countries could join together to out-vote the U.S. This contrasts with the IBRD, in which industrialized countries controlled 75.6% of total voting shares in 1960 (Figure 2.2). But with 42% of voting power, the U.S. needed to ally with only one of the larger countries to block any actions. As well, the U.S. demanded veto power over FSO operations, due to the fact that it contributed two-thirds of the initial resources of the concessional fund. And perhaps most importantly, the charter stipulates that for any increase in the capital stock of the bank or any changes in the charter itself, a "special majority" of 75% was required, giving the U.S. veto power over the future evolution of the bank (Ibid.). There is no record of dissent on this point during the convention, nor was there serious opposition to naming Washington DC to be the bank's headquarters (Broide, 1961), which suggest that the Latin countries were well aware of the limits of the U.S.'s benevolence.

Figure 2.2. Voting Power at the IADB



Source: Annual reports World Bank and IADB, 1960.

2.2.2 Borrowers' Honeymoon

The dominance of the U.S. was not a cause of conflict in the early years of the IADB's existence, for the simple reason that the intentions of both the U.S. and other member governments were relatively closely aligned. All parties involved wanted to ramp up the flow of external capital to Latin America and to undertake loans that the World Bank did not consider, in particular for social projects and industry. The early activities of the IADB must have come as a pleasant surprise to most of its borrowers. Concessional lending quickly assumed a large role in the new bank. The Kennedy and Johnson administrations funded FSO lending to the tune of US$2.275 billion between 1960 and 1967.[21] As a result of this generous amount of concessional resources, US$1.46 billion of the IADB's US$2.43 billion in total lending commitments up to 1967 (63%) was at concessional interest rates, while the remaining US$863 million (37%) was at the regular lending rate. By contrast, of the World Bank's US$7.2 billion in total global loan commitments over the same period, only US$1.7 billion (24%) was in concessional lending, compared to 76% at market-based rates.

[21] The U.S. created the Social Progress Trust Fund as another concessional lending window within the IADB under direct U.S. control in 1960, but by 1965 it had been merged into the FSO.

Because of generous U.S. support, the IADB was considerably less exercised than the World Bank had been in its early years to ingratiate itself with private capital markets. As one early observer of the IADB noted, "The bank has not felt itself constrained, as its sister institutions have done, to tailor its operations to fit the assumed expectations of the prospective purchasers of its bonds" (White, 1975, p. 182). Also, the task itself was much less difficult than it had been in the late 1940s, because of all the work the World Bank had already done to ease market concerns about a multilateral bank. This was highlighted by the fact that the IADB's first debt issuance in the U.S. was rated AAA with a minimum of fuss, and sold out in short order at the same terms as IBRD bonds in the same year (IADB, 1963). Thus, the very same conservative financial policies of the World Bank that in large measure led to the creation of the IADB allowed the new bank to immediately differentiate itself from its predecessor in ways that suited both its borrowing members and its dominant shareholder.

The strong U.S. commitments of concessional resources gave the IADB considerable leeway, both rhetorically and operationally. The Economist magazine, in an article on the IADB's creation, noted that the new bank's goals included "rather striking new specifications for social reform" (1960, p. 241). The very first loan made by the IADB was for a water and sanitation system in Arequipa, Peru—a clear statement of the new bank's intentions (IADB, 1961). Lending in the early years of the IADB followed these new priorities. Two-thirds of all lending commitments in the first four years of operations were for industry and social infrastructure, compared to only 4% by the World Bank in the same years to Latin America and 15% globally.[22] By contrast, only 10% of total IADB lending was for electric power and transportation infrastructure, compared to 88% for the World Bank in Latin America and 70% globally.

The IADB also showed in the early years a notable tendency to lend to all member countries, regardless of their economic or political policies or their relationship with the

[22] Compiled from World Bank and IADB annual reports, 1961-1964. World Bank includes IDA, IBRD and IFC. The difference between Latin American and world lending sectoral breakdowns for the World Bank may indicate a small degree of substitution effect, taking into account the IADB's operations. Nonetheless the broader differentiation between the World Bank and IADB is striking.

U.S. Here again, this contrasts with the World Bank's focus on creditworthy borrowers, as described in the previous section. One interesting case in point was Brazil, governed by a left-leaning administration from 1958 to 1964 that vocally opposed the U.S. The World Bank granted no loans to Brazil between 1958 and 1965, while the IADB granted numerous loans every year to Brazil, with no apparent objection from the U.S. Similarly, Colombia engaged in a heated dispute with the IMF in the mid-1960s over macroeconomic policies (Dell, 1972), which led a halt in World Bank lending during 1965. Again, the IADB continued lending to the country throughout. It would seem that the U.S., intent on repairing relations with the hemisphere, was willing—for the time being—to resist the temptation to use its power in the IADB to further its own interests, and allow the IADB to build a reputation for autonomy and solidarity among Latin Americans.

2.2.3 Failed Efforts to Diversify Financing Sources

Concessional support from the U.S. remained strong up to the late 1960s, and the IADB could access U.S. capital markets at terms comparable to the U.S. for its limited private market needs. However, the IADB had considerably less success accessing resources from outside member countries, a problem which would grow in importance in the 1960s and early 1970s. No doubt looking at the successful experience of the World Bank in European capital markets, the IADB expected bond issues in European markets to be a major source financing. President Felipe Herrera, speaking at the first meeting of the Board of Governors in 1960, stated confidently that "I am convinced…that these possibilities [for bond issues] will be found not only in the financial centers of the United States, but also in the capital markets of Western Europe" (IADB, 1960).

Herrera would soon be disabused of this notion. The IADB faced several obstacles to entering European markets, including regulations, high taxes (up to 2.5% per issue, compared to the tax-exempt status of World Bank bonds) and outright prohibitions erected by European governments against IADB bond issues in their markets (IADB, 1965a). The key point was membership, as the IADB acknowledged in a 1965 study: "The IADB has found that these countries give preference to certain countries linked to them politically or economically, or to international institutions of which the country is a member" (Ibid., p. 65, author's translation). Europeans understandably viewed the IADB as dominated by the U.S., and they apparently had no interest in offering it the advantages enjoyed by international organizations such as the World Bank or the European Investment Bank, which they were members of and had a voice in.

The only mechanism by which non-member countries offered significant capital was loans or credit lines tied to purchases of export goods. Essentially, developed countries were using the IADB to subsidize exports to Latin America. By 1968, Canada, Netherlands and the UK had committed US$95 million for the IADB to on-lend, almost all of which was restricted to purchase exports from those countries.[23] Although the IADB accepted these tied capital contributions, it did so only grudgingly. President Herrera voiced his preference for other options in 1965: "Undoubtedly, the best system from our standpoint is prospective bond issues, direct government loans, or participation in sales permitting *free use* of additional contributions to our ordinary capital… We have made it clear that the Bank's role in these transactions is not that of an instrument designed to promote exports by developed countries" (IADB, 1965b, p. 16, author's translation and emphasis added).

2.2.4 Something New—But Will it be Sustained?

By 1968, the U.S. was looking at a dramatically different global panorama and economic circumstance than at the start of the decade. In Latin America, the initial panic triggered by the Cuban revolution had subsided. The U.S. was actively supporting the growing militarization of the region's political systems, which limited the threat of communist takeovers. By 1968, right-wing military regimes had taken control in Argentina, Brazil, and the Dominican Republic, with Uruguay, Ecuador, Chile and Bolivia soon to follow. At the same time, Vietnam had become an expensive fiasco, domestic fiscal policy was escaping control, and the country was facing increasingly severe balance of payments problems. Support for foreign aid—particularly in the U.S. Congress—was on the decline.

[23] Only Sweden contributed untied funds for the IADB to lend out of OC resources, but just US$5 million.

In the face of these new developments, the U.S. began scaling back contributions to the IADB. After giving US$1.8 billion in concessional resources in the first eight years of IADB operations, it contributed only US$500 million in the subsequent eight years, and that only after long delays by Congress. The U.S. also began taking an active interest in halting lending to countries with which it had business disputes, notably nationalization moves against U.S. companies in Chile and Peru.[24] In December 1970 the U.S. Congress passed HR 18306, which required that the newly-created National Advisory Council submit reports on the activities of all MDBs that the U.S. supported, justifying that their activities did not negatively impact U.S. foreign policy, particularly with relation to expropriations of the assets of U.S. companies (Dell, 1972). Leftist Peruvian President Juan Velasco in 1968 had nationalized a subsidiary of the U.S. energy giant Standard Oil, and in a speech at the 1971 IADB Board of Governors meeting in Lima, he railed against the U.S. for halting loans to his country because of the dispute—a rare public display of the tensions brewing at the IADB.[25]

The declining concessional capital available from the U.S. government coupled with the growing interventionist attitude of the U.S. in lending operations, spurred IADB management to take a more proactive position about finding new sources of funding. The IADB management under President Antonio Ortiz Mena saw greater use of OC compared to FSO resources as a way to make the IADB less susceptible to U.S. pressure, as Ortiz Mena spelled out in a 1973 speech: "…it is perfectly clear that the Latin American countries as a whole have sufficient voting power to approve loans granted with the ordinary resources of the Bank. A very different case is that of the Bank's operations financed with the resources of the Fund for Special Operations" where the U.S. had a veto on all loan approvals (IADB, 1973, p. 48). If the Latin countries wish to reduce the

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[24] The only lending in those countries between 1969 and 1971 was, in the case of Chile, two small FSO loans to private universities; and in Peru, a US$30 million emergency loan after the earthquake and landslide of 1970.

[25] "We believe that the time has come for a calm and complete reappraisal of the real effectiveness of an institution which, like the Inter-American Development Bank, shows signs of being used as a tool for political pressure against countries which, like Peru, are determined to break with the past." IADB, 1971, p. 26.

power of the U.S. in IADB operations, then strengthening the OC window and depending less on FSO was the way forward.

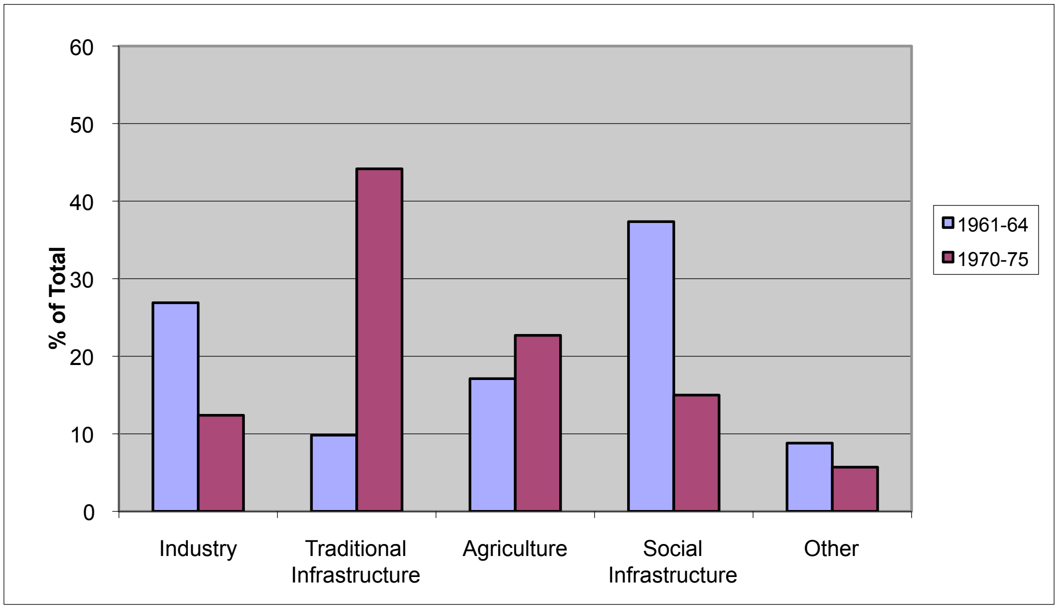
Ramping up non-concessional lending, however, required the IADB to have access to a steady stream of bond purchasers. This, in turn, required the IADB to pay much more attention than previously to convince the markets that its securities were a safe investment, much like the World Bank. Thus it comes as no surprise that by the early 1970s, IADB financial policies increasingly began resembling the World Bank. In a 1972 speech to the IADB's Board of Governors, Ortiz Mena alluded to the need for the IADB to pay close attention to the views of bond holders when considering loan applications in light of the greater need to raise money on the markets: "…we should bear in mind that the financial soundness of the Bank and its loan portfolio is subject to constant appraisal when it has recourse to capital markets. Our Bank's capacity to maintain its prestige in those markets redounds to the benefit of member states, not only in regard to the amount of resources it can mobilize but also in regard to their cost and other terms" (IADB, 1972, p. 157).

The change was most dramatic in what types of projects the IADB supported in the first half of the 1970s compared to a decade earlier. The IADB's early enthusiasm for lending directly to private industry—a Latin American priority—began to abate. This was no doubt in part encouraged by the default and write-off of two private sector loans in 1966 in Argentina and Brazil, and a third in Chile in 1972[26]—not something bond holders would be keen on seeing repeated. By 1970 direct private lending had dropped to only 6% of total OC lending, and it was cut off entirely after that year. Loans to the private sector via national development banks (which offered greater repayment security because of public sector backing) fell from 46% of OC commitments in 1961-64 to 14% in 1970-74. Social infrastructure lending also declined sharply. By contrast, the IADB rapidly scaled up lending to traditional infrastructure projects such as highways and electric

[26] US$8.4 million default in Brazil 1966 that spent several years in the courts; US$2.8 million default in Argentina in 1966 (leading to a US$1.8 million charge against reserves); and US$9.6 million default in Chile in 1972.

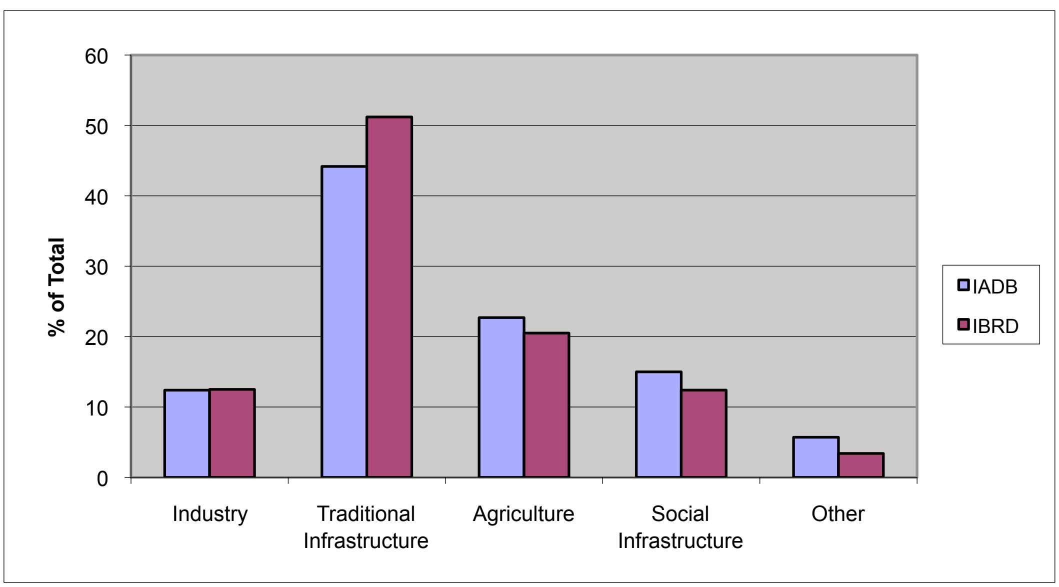
power (Figure 2.3). This new patterns is very close to the lending priorities of the World Bank, in sharp contrast to their divergence in the early 1960s (Figure 2.4).

Figure 2.3. IADB Commitments by Sector



Source: IADB annual reports, 1961-64 and 1970-75.

Figure 2.4. World Bank and IADB Commitments by Sector, 1970-1975



Source: IADB and World Bank annual reports, 1970-75.

2.2.5 Branching Out to Non-Regional Members

While these efforts to reshape lending policies undoubtedly helped assuage investors, the IADB faced another problem starting in the early 1970s: restrictions on entering the U.S. capital markets. With its growing balance of payments difficulties, the U.S. government had taken to limiting bond issues by both the World Bank and the IADB in the New York market (IADB, 1970a). The only other markets available for bond issues were in Europe and Japan, and as discussed above the IADB had serious difficulties in accessing those markets because these governments were not members of the IADB. In his farewell address to the Board of Governors in 1970, President Herrera suggested that financial pressures and the lack of alternatives were leading the IADB to reconsider its original intention of limiting membership to countries in the region: "In the case of non-member countries, this encourages us to seek other formulas designed to maintain an adequate additional flow of resources…including possible formal association of those countries with our organization" (IADB, 1970b, p. 67).

Canada was admitted to the IADB with little controversy in 1972 (IADB, 1973), but the financial impact was minimal. A more thorny matter was the admission of a dozen prospective members from Europe and Japan. From the point of view of the IADB, these countries represented a critical financial lifeline, as noted by Ortiz Mena in 1973: "Their membership will facilitate our access to certain capital markets on more favorable conditions than at present…Furthermore, the diversification of sources will help diminish the possibility of sharp fluctuations in the flow of funds received by the Bank" (IADB, 1973, p. 50). The move to bring in additional wealthy countries from outside the region did not sit easily with all borrowing countries. Peru's representative to the IADB Board of Governors gave guarded approval to the expansion: "…we trust that before long we may be able to extend an equally cordial welcome to other countries of Europe and Asia, on the understanding that their presence will not imply political interference…" (IADB, 1972, p. 7-8). Speeches by the representatives of Argentina, Venezuela and Peru at IADB meetings in 1973 and 1974 spoke of the need to "Latin Americanize" the bank, including an unsuccessful proposal to move its headquarters to Latin America.

Despite these misgivings, nine non-regional countries were admitted as new members on July 9, 1976: Belgium, Denmark, Germany, Israel, Japan, Spain, Switzerland, United Kingdom and Yugoslavia. The new non-borrowing members were granted two full seats on the Board of Executive Directors, although the total voting share of Latin American nations in OC operational decisions and in the Board of Governors remained above 50%. In return, the new members agreed to contribute US$745 million total additional resources: US$372 million to FSO and US$372 million in ordinary capital, of which US$61.5 million (16.5%) was in cash and the remainder on call. Equally important, new members granted the IADB full legal and tax status as an international organization, and facilitated the placement of bonds in their capital markets (IADB AR, 1976). The results were immediate. IADB debt issued in non-member countries had averaged US$53 million per year in 1961-75, but that immediately jumped to US$252 million in 1976—almost twice the previous record amount in one year (US$145 million in 1969) (IADB AR, 1976 and IADB AR, 1969). In 1977 the IADB floated its first public bond in Japan, which was to become a major purchaser of IADB debt in coming years, and borrowing also ramped up sharply in the German and Swiss markets (IADB AR, 1977). This new level was sustained going forward, with the IADB issuing on average US$221.5 million each year 1976-1980 (IADB AR, 1976 to 1980).

2.2.6 Summarizing Findings

The IADB was created directly in opposition to the World Bank. Its aim was to lend for development projects that the World Bank would not touch, especially social infrastructure and private industry; to offer more concessional resources; to reduce political influence in lending; and to generally take a less market-focused view of its development mission. It was successful in all these areas in the first years of its existence, specifically because of the very high level of resources committed to it by the Kennedy and Johnson administrations, in reaction to U.S. fears of social revolt in the Americas. The IADB could also get away to a degree with being less focused on the views of bond buyers than the World Bank could when it began, simply because the World Bank had already done much of the heavy lifting needed to gain market acceptance for MDB securities.

But as U.S. support for concessional lending began to wane in the late 1960s, the model quickly began showing its limitations. The IADB found that it couldn't get significant financial support from elsewhere in the world, as no other countries had any stake in the IADB. The only resources made available were linked to export finance, which suited the interests of wealthy nations but restricted the IADB's operational ability and often did not suit the needs of borrowers. As U.S. capital markets began to tighten in the late 1960s, the IADB was forced to reconsider its organizational model. By 1970, it shifted its focus to non-concessional lending, which not only didn't depend on U.S. contributions but also afforded Latin countries greater operational control due to voting rules. The shift to non-concessional lending, however, necessitated greater access to private markets to raise capital. This in turn led to a dramatic change in lending patterns, away from social infrastructure and private industry and toward the type of power and transport projects favored by the World Bank to impress potential bond buyers. Also in a bid to access more resources and to counterbalance U.S. influence, the IADB sacrificed a degree of its Latin American character and allowed members from outside the region.

Thus the evolution of the IADB between its founding in 1959 and the radical transformation in the mid-1970s puts in sharp relief how the pressures of securing the resources needed to function to a large measure dictated not only the bank's operations but its very membership structure. The IADB began its life very different than the World Bank, but by the mid-1970s had moved much closer to the World Bank's model of MDB operations. This was the direct result of the need to raise more resources on private capital markets in the U.S. and abroad, combined the evolving interests of the US, non-member wealthy nations and Latin American members.

2.3 CAF: The Challenges of Going it Alone

Like the IADB, the Andean Development Corporation (*Corporacion Andina de Fomento*—CAF) was envisioned by its creators to be a new sort of MDB, one that would undertake a different type of development activity than either the World Bank or the IADB. The specific role intended for the CAF was to promote economic integration among the six South American countries that formed the bank—Bolivia, Chile, Colombia, Ecuador, Peru and Venezuela. This effort at regional integration was part of the broader development strategy prevalent in Latin America at that time of inward-looking development and deepening regional trade links. The Andean Group was one of the most notable of these efforts. The CAF was mooted right at the beginning of the negotiations to create the Andean Group, and the treaty creating it was signed on February 7, 1968—even before the 1969 Cartagena Agreement formally created the Andean Group.

The operational structure of the CAF mirrored the examples of the World Bank and IADB in many important respects. It followed the model of a corporation, owned by six shareholders governments who contributed the initial capital and were the final arbiters of its policies. The CAF was designed to use its capital and other public or private resources it might raise to make loans, which would be paid back with sufficient interest to ensure the financial stability of the organization. Within this broad model, however, the CAF differed from the World Bank and IADB in a number of important respects.

Most notable was the composition of the shareholding countries themselves: they were all developing countries expecting to borrow from the CAF, with no non-borrowing developed countries involved. As well, participating countries would have equitable control over the CAF, while still taking into account differences in wealth among the six, through the creation of different types of shares. The initial US$25 million in capital was divided into six "A" share worth US$1 million, purchased one each by all member countries. The remaining US$19 million would be in "B" shares, of which Chile, Colombia, Peru and Venezuela purchased 22 percent, while Bolivia and Ecuador purchased 6 percent. The voting rules of the bi-annual shareholder assembly as well as the composition and voting rules of the Board of Directors were written to ensure that the A shares of Bolivia and Ecuador gave those countries significant voice, despite their lower contributions. Most notably, either country could veto any changes to the CAF statutes or structure of the Board of Directors (Fresard, 1969). This relatively equitable shareholding governance arrangement is fundamentally different from the World Bank and IADB, in which relative economic and political power was reflected directly in the amount of capital and voting share of each member country.

Another important difference was the administrative mechanics of the CAF compared to the other two MDBs. The differences between shareholders in the World Bank and IADB that led to heavy oversight and permanent sitting executive boards was non-existent in the CAF, since shareholders were all borrowing countries themselves and had very similar interests. This is clearly reflected in the administration. Rather than having all lending decisions approved by a full-time, in-house board of directors representing shareholders, the CAF board was designed to meet only twice a year to approve the broad outlines of its strategy. This arrangement was explicitly intended to allow the CAF to act rapidly and with a minimum of bureaucratic hassle, as noted by one of the original treaty negotiators: "…all these stipulations were included to avoid rigid situations that could slow down activities, and to provide the organization the maximum agility and flexibility" (Fresard, 1969, p. 34, author's translation).

The orientation of the CAF's financial services was also intended to be markedly different from the World Bank and IADB, filling a gap that—despite the repeated requests of borrowing governments in Latin America—neither of these two MDBs filled. Industry, and to a lesser extent agribusiness and trade support, were to be the explicit and exclusive focus of the CAF's activities (Ibid.). Financial support could be supplied in a broader range of ways than other MDBs, including to "emit bonds or debentures, act as a guarantor of any type, provide collateral for obligations, and grant guarantees in share issues", i.e. act as an underwriter (CAF, 1974, Art. 4).

2.3.1 Early Problems: Raising Resources and Finding Suitable Projects

Among the many problems facing the CAF when it opened its doors for business in 1970, by far the most pressing was raising resources with which to operate. The six founding countries had committed US$25 million in capital, but this would only be paid in over the course of several years, making it essential that the CAF quickly find other sources of capital to intermediate. The expectation of the CAF's creators and early administrators was that this capital would mainly come from outside the region. As the Chilean negotiator blithely stated, "…the majority of the resources that the Corporation will employ will not come from its own capital, but from traditional sources available in the developed world for the purposes of economic and social development" (Fresard, 1969, p. 33, author's translation), evidently meaning soft loans from bilateral aid agencies of developed countries or other, larger MDBs. As well, the CAF—apparently thinking it would not be difficult to emulate the financial operations of the IADB and World Bank—intended to issue debt on private capital markets in Europe and North America, as envisioned in its charter.

Initial impressions seemed positive: U.S. AID provided a US$15 million soft loan in 1971, and Canada soon followed suit with another US$5 million. Further financial contributions were expected from the World Bank and, especially, the IADB: "An initial participation of the IADB is expected with a loan on the order of US$12 million, which would not preclude further loans when these resources have been used and the necessities of the organization require it" (CAF AR, 1971, p. 33, author's translation). The CAF sent out a financial mission to Europe, Japan and North America in 1971 to test the waters regarding access to other public and private sources of capital in the form of credit lines, bond issues and bank loans. The mission reported receiving a "favorable and positive impression on the aims of the organization" (Ibid., p. 34, author's translation) in international financial circles. One of the stops was in Switzerland, where CAF officials met with the banking giant UBS to "understand the conditions under which the institution could in the near future place in the world capital markets a long-term bond issue" (Ibid., p. 34, author's translation).

However, these optimistic plans soon came up against a much less forgiving reality, which must have come as an unpleasant shock to the CAF. U.S. AID's US$15 million loan, which the CAF saw as just an "initial" contribution (Ibid., p. 34, author's translation), was never increased, nor was the Canadian loan. Efforts to raise money from European governments were similarly limited, with the 1975 Annual Report reduced to playing up the fact that a CAF European mission had even been received by "high officials" at all (CAF AR, 1975, p. 16, author's translation). Following the oil shock, the CAF was quick to send a 1975 mission to Arab countries in an effort to raise capital, with no success. The IADB was similarly uncooperative. After an initial loan of US$750,000 for technical assistance purposes, no further resources were forthcoming. Various formal loan applications with the IADB continue to be discussed in annual reports until 1978, after which the topic is no longer mentioned. Similarly, hopeful mention is made in the 1974 Annual Report of obtaining from the World Bank "technical and financial cooperation for the programs of the CAF and, eventually, a line of credit" (CAF AR, 1974, p. 25, author's translation), which never materialized. With U.S. enthusiasm for development aid dwindling, and the lack of any shareholding influence by the U.S. or European nations, developed country governments apparently saw little incentive to supply resources to the CAF.

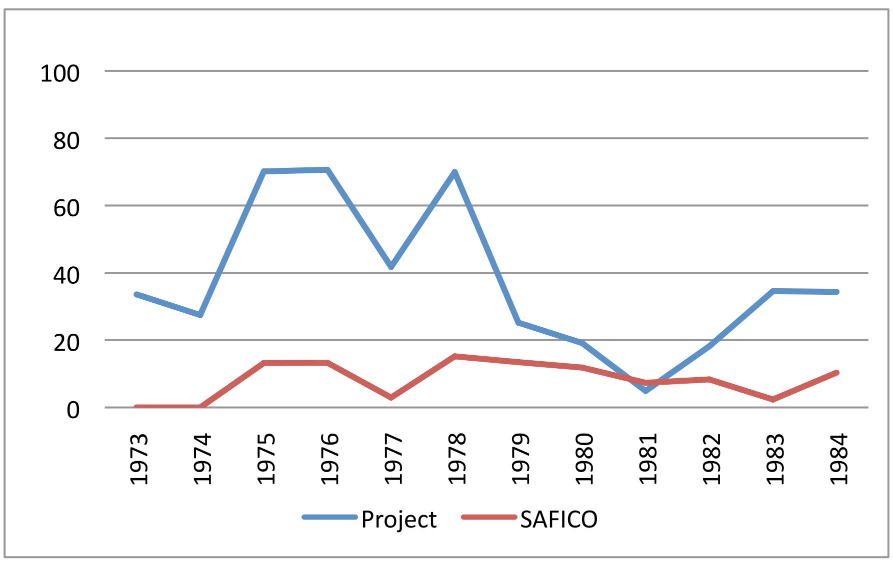
Progress was even slower with the private markets. Neither U.S. nor European capital markets showed any inclination to invest in CAF bonds. Following a 1974 mission to New York investment banks, the CAF concluded that "during 1975 there will be possibilities to raise US$15-25 million in a private placement, as a first step before a future public offer" (Ibid., p. 23, author's translation). No such placement took place. Talks with European and Asian banks that same year were similarly fruitless. In an explicit effort to strengthen the financial image of the CAF in international capital markets, shareholders approved the creation of US$200 million in callable (or guarantee) capital in 1974 (Ibid.), following the model of the World Bank and IADB, but with no apparent impact. The first private financial participation from outside the region were a series of loans by Bank of America in 1973, 1974 and 1975, but these were at a high interest rate (above 11 percent) and directly tied in with a U.S. Ex-Im Bank loan for specific U.S. export purchases (CAF AR, 1973, 1974 and 1975). Even with the huge boom in petrodollar lending to Latin America, it was not until 1977 that the CAF was finally able to conclude a sizeable bank loan, for US$50 million from a syndicate of European, Japanese and U.S. banks. With no developed country to back up its financial obligations—only six relatively poor Latin American countries, two governed by leftist administrations whose leaders regularly railed against the evils of capitalism—and an unclear mandate based on vague notions about regional integration and solidarity, financiers in developed countries could be forgiven for not being more enthusiastic about lending it money.

Like the IADB in the 1960s, credit lines and loans tied to exports were the only significant financing offered by countries outside the Andean region: US$6 million each from Brazil and Mexico in 1973, US$10 million from Japan's Ex-Im Bank in 1974, various projects purchases funded jointly by the U.S. Ex-Im Bank and Bank of America, and US$10 million by the Spanish Export Bank in 1977 (CAF AR, 1973, 1974 and 1975). The CAF sought to avoid credit lines tied to exports, as they limited both the financial flexibility of the CAF and the procurement options facing borrowing projects. The 1973 Annual Report highlights "the necessity that [external] loans and credit lines be granted totally untied and in conditions that facilitate their use in programs compatible with the necessities of the CAF" (CAF AR, 1973, p. 20, author's translation).

As a result of these obstacles, the CAF was forced to rely much more heavily than it had originally expected on capital raised within the six member countries. By 1980, the CAF had raised a total of US$260 million from its members, compared to US$137 million from outside the sub-region (CAF AR 1970-1980). This is a far cry from the lofty expectations that the CAF would become a conduit for significant amounts of private and public capital from wealthy countries into the Andean region.

If the CAF's liability situation was difficult during its first decade, its asset side was equally so. Right from the start the bank ran up against the tensions between its mandate for using lending to promote sub-regional integration and the desires of individual member governments. The CAF sent out an initial mission in 1971 to all member countries to put together a portfolio of potential projects. However, as that year's annual report noted, "The most common characteristics of these projects and initiatives was their limited integration content. The majority had strictly national characteristics…" (CAF AR, 1971, p. 21, author's translation). This problem was mentioned repeatedly in early annual reports (see for example CAF AR, 1973, p. 29). The solution was to partially relax the CAF's standards in the interests of making loans. In an article describing this period, the CAF's second president recalled that "pressured by the need to survive, the CAF had to move ahead with projects that were not strictly in accord with the restrictive parameters of its mandate" (CAF, 1990, p. 28, author's translation).

Figure 2.5. CAF Lending Commitments (millions 1973 US$)



Source: CAF annual reports, 1973-1984.

Note: SAFICO refers to short-term trade finance of not more than 90 days.

By partially relaxing its project lending requirements and initiating short-term trade finance lending (called SAFICO), the CAF began to build lending, with annual commitments rising from US$33 million in 1973 to US$107 million in 1976 (of which US$17 million was trade financing). However, lending reversed sharply in 1977, as a result of the withdrawal of Chile—now under the sway of Pinochet's free market

“Chicago Boys”—from the Andean Group, as well as changing development strategies of member countries. After a temporary rebound in 1978, lending commitments continued to decline to 1981 (Figure 2.5). Equally troubling was the CAF’s operating results, with three years of net losses (1975, 1977 and 1978), reflecting not only to difficulties finding appropriate projects but also the CAF’s high cost of capital, which made it problematic to on-lend at terms that were both acceptable to borrowers and profitable for the CAF (CAF, 1990).

2.3.2 Changing Direction in the 1980s

By 1981, the CAF’s finances were in a precarious state, with only US$15 million in loans committed that year. From this low point, the CAF began reorienting its strategy and rebuilding itself as a viable financial intermediary. Leaving behind an operational model that paid scant attention to its own bottom line, and hamstrung by a mandate to promote a sub-regional integration process that was at best stagnating, the CAF began the painful process of reinventing itself as an MDB much closer to the model of the IADB and World Bank. In the 1981 inaugural speech of President José Corsino Cárdenas, he called for the CAF to “adjust its institutional structure and launch new initiatives such that it can convert itself into…a true financial agent for its shareholders and an organization that does more than just survive” (CAF, 1981, p. 13, author’s translation).

This meant, first and foremost, revamping the CAF’s operational activities to boost its attractiveness as a potential lender. The board approved a new Operations Policy in 1983, “broadening the realm of activities for the promotion, development and financing of projects, incorporating sectors such as physical integration [i.e., transport infrastructure], agricultural development, industrial rationalization, developing capital goods industries and conservation of natural resources…” (CAF AR, 1983, p. 7, author’s translation). The aim was to “overcome the limitations of the existing operations policy, designed basically for industrial programming and free trade within the Andean Group” and now “attend more directly the sectors that most contributed to the economic development of the countries such as agriculture, agroindustry, physical integration, and other areas previously not addressed by the CAF” (CAF, 1986, author’s translation).

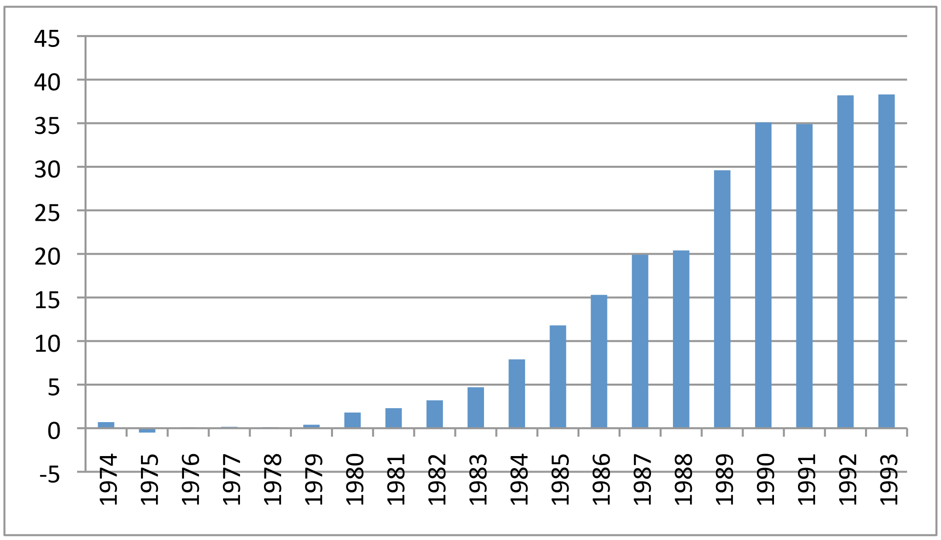
Other shifts in lending policy were apparent beginning in the early 1980s. By 1982 the CAF had finally signed a cooperation agreement with the IADB (CAF AR, 1982), which allowed the CAF to co-finance several operations in the 1980s, providing a degree of security for the CAF to lend larger amounts for projects vetted and overseen by the IADB. As well, CAF loans increasingly went directly to governments or government-run companies and development banks, rather than the private sector—similar to the trend in IADB lending in the late 1960s and early 1970s. This provided a higher degree of security to the CAF in troubled economic times and allowed for larger loan amounts, and would have been welcome to borrowing governments in the extremely difficult panorama of the early 1980s.

As a result, CAF lending stabilized and began growing again in the 1980s—an impressive feat considering the dire economic situation in Latin America at the time. Project loan commitments rose each year (apart from a brief downturn in 1989), climbing from US$40 million in 1982 to US$263 million in 1990 (CAF AR, 1980-1990). Perhaps as importantly, the CAF evidently began selecting projects much more carefully, as indicated by the reduction in cancelled projects from 43% of total value during 1971-1980 to 10.6% in 1982-1986 (CAF, 1986). The overall financial stability of the institution was on a much more solid foundation, with net income up from US$1.8 million in 1980 to US$15.2 million in 1986 and US$35 million in 1990 (Figure 2.6).

The evolution of reserves is even more telling about the changing mindset of the CAF over the course of the decade. Reserves were actually in negative territory for much of the 1970s, after being used to cover operating losses in 1976 and 1978, and totaled a mere US$300,000 in 1980. The incoming administration in 1981 clearly understood the implications of reserve policy and began systematically building reserves each year. By 1986, reserves totaled US$22 million, climbing to about US$100 million in 1990 (CAF AR, 1970-1990). Equally noteworthy is the fact that the administration convinced shareholders to allow the CAF to keep unallocated net income on its books as it began to accumulate in the 1980s, rather than redistributing it to shareholders as permitted by

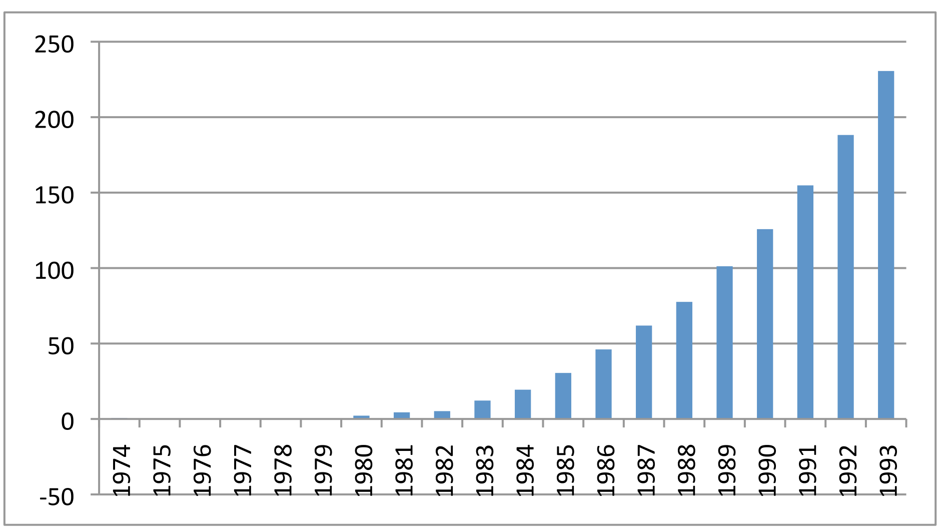
Article 42 of its founding agreement. By 1990, accumulated and unallocated net income totaled US$28 million—useful to generate extra financial income from investments, provide a liquidity cushion and offer additional confidence to potential investors (Figure 2.7).

Figure 2.6. CAF Net Income (millions current US$)



Source: CAF annual reports, 1974-1993.

Figure 2.7. CAF Reserves + Retained Earnings (millions current US$)



Source: CAF annual reports, 1974-1993

Another critical action was for shareholders to double their paid-in capital, from US$100 million to US$200 million, and to subscribe another US$200 million in callable capital.

This not only directly gave the CAF more financial resources, but also signaled to potential private and public sources of financing of the commitment of member countries to back the CAF. The new subscription was approved in 1983 (CAF AR, 1983), and authorized capital was increased again to US$1 billion in 1986 (CAF AR, 1986), US$200 million of which was for “C” shares, with the explicit purpose of attracting shareholders—and hence more capital—from outside the sub-region: “…it is important to highlight the qualitative change that the presence of extra-regional partners would signify, as it will permit the institution to access capital markets utilizing the guarantee capital that the new partners would provide” (CAF, 1986). While the C shares had subordinated voting power, this move nonetheless reflected the CAF’s willingness to adapt its original model of a purely sub-regional organization to remain financially viable.

2.3.3 Coming Into Its Own

As was the case with the IADB in the 1960s and early 1970s, it was increasingly apparent to the CAF that official, bilateral sources of soft loans would be limited and fickle, and the more easily available credit lines tied to exports of developed countries severely restricted the CAF’s ability to fund different types of projects. The answer would be private capital markets, as President Galo Montano stated in a 1989 speech: “Our interest in freeing ourselves from the dependence on the type of resources that we currently channel has led us to study ways of raising resources on the international market” (CAF, 1989, p. 10, author’s translation). The overhaul of operations and finances to stabilize the CAF and project a more conservative, financially reliable image positioned the CAF well when international capital flows to developing countries began to pick up again in the 1990s.

One point in the CAF’s favor from the point of view of potential creditors was the fact that no sovereign borrower had ever defaulted on a loan, even though four of the CAF’s five member governments were in default to international markets at some point. Even when Peru suspended paying international debt and fell into arrears with the World Bank, IMF and the IADB in the mid-1980s, it continued servicing all obligations to the CAF.

This track record was due to two related reasons. First, and most obviously, the CAF was created and completely controlled by the very countries that it lent to. Second, the bulk of the CAF's capital came from member governments themselves or their domestic markets. Hence governments would have had a very strong interest in ensuring that the CAF was repaid in a timely manner.

Indications that others outside the region were beginning to take notice of the CAF's unsurpassed repayment track record and the reforms to its operations came in 1989, with the first placement of a private bond (albeit only for US$2.5 million) with First Interstate Bank, followed the next year by a three-year, US$15 million bond placed privately in Japan at Libor +1% (CAF AR 1989 and 1990). This was a critical sign of confidence of the private markets in the CAF's financial probity. In 1990 the CAF also received US$30 million in untied credit lines from German and Dutch banks, and further untied loans from First Interstate for US$8 million (CAF AR 1990). In that same year, Mexico became the first member from outside the Andes to join the CAF, via the purchase of a portion of C shares, and the CAF authorized commercial banks from the region to sign up for a portion of B shares.[27] In further recognition of the growing perception of shareholders about the CAF's usefulness and reliability, authorized capital was increased by US$1 billion in 1990, to a total of US$2.05 billion (CAF AR 1990).

The quantum leap in the CAF's performance came with the arrival of Luis Enrique García as president in 1991. An IADB staffer for 17 years—including a stint as IADB treasury sub-director—García completed the transition of the CAF's business model to one much closer to the IADB. He was clear about his goal right from the start, as he described in a later interview: "When I joined the CAF, particularly because of my experience with the IDB, I saw the future of the CAF as an institution relying essentially on CAF's ability in the future to tap the international capital market. Because if it was only relying on the old capital or short term lines of credit or even loans from the IDB, the institution really had no chance to grow. So the challenge was to get to the capital markets." (Latin Finance, 1998, p. 147). Thus, while the CAF was being pushed by the

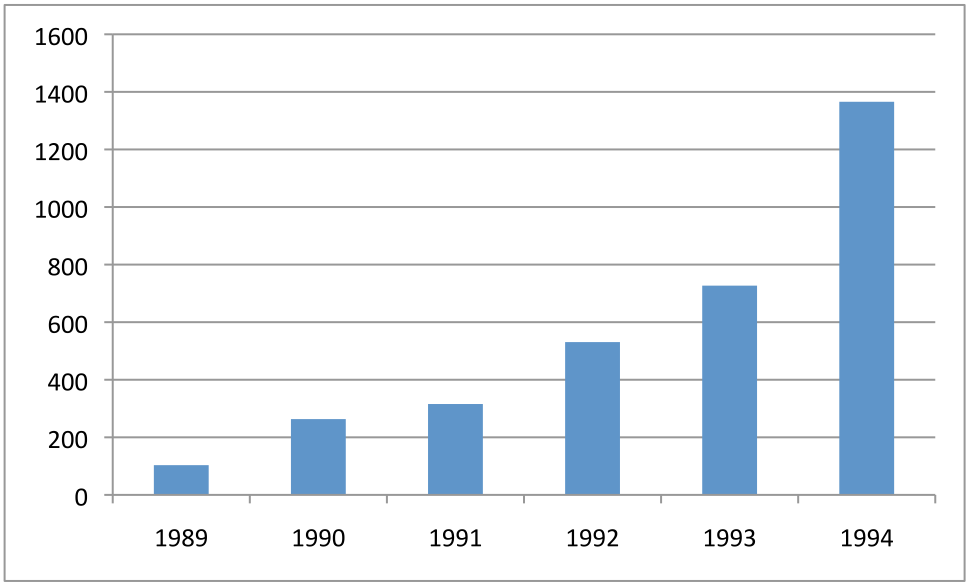
[27] Three banks signed up the first year, and eventually a total of 23 banks joined the CAF (14 as of 2010).

realities of its organizational model and finances in the direction of the other two MDBs, García had the experience and clarity of vision to see that process through in a decided fashion.

But for the CAF to raise significant resources on the markets at a price that permitted the CAF to on-lend at reasonable rates, "it was a must to have an investment grade rating," García noted in the same interview (Ibid.). Immediately after taking charge in 1991, García traveled to New York to obtain a rating from Standard & Poor's and Moody's. This was an ambitious request, considering that not a single borrower in Latin America had investment grade, and that four of the five government shareholders of the CAF were among the most notorious debt trouble spots in the world during the 1980s. The CAF also hired consultants from Coopers and Lybrand and a former World Bank vice president to review the CAF's operations and make recommendations for overhauling internal process, and revised operational and financial policies "with the aim of broadening its sources of financing and adjusting to the new global dynamics" (CAF AR, 1992, p. 57, author's translation).

Doubling authorized capital in 1990 also helped in this goal, as did the expansion of membership beyond the Andean Community. Mexico joined in 1990, Chile returned in 1992 and Trinidad and Tobago joined membership in 1993, although from the start García expressed his intention to bring in more developed countries as members: "I think a first step is to increase the number of C series shareholders. Not only the incorporation of other regional countries, but to fix as a goal the incorporation of industrialized countries. This will significantly facilitate the access of the CAF to international markets" (CAF, 1991, p. 17-18, author's translation).

Figure 2.8. CAF Project Lending Commitments (millions current US$)



Source: CAF annual reports 1989-1994.

Standard & Poor's issued the CAF an investment grade rating in 1993, soon followed by Moody's and IBCA (CAF AR, 1993). During the same year, the CAF issued three public bonds for a total of US$289 million, US$200 million on the Eurobond market and US$89 million Japanese "samurai" bonds (Ibid.). In one year the CAF raised more freely usable resources from outside the sub-region than it had in its entire previous two decades combined. Project lending commitments increased by more than a factor of 10 in the five years between 1989 ($103 million) and 1994 ($1.4 billion)—a truly remarkable growth rate (Figure 2.8). The benefits of the CAF's reorientation toward the private markets were thus immediately made clear to all involved.

2.3.4 Summarizing Findings

Like the IADB, the CAF was founded explicitly to address the limitations of existing MDBs, by extending credit to private industry under a regional integration framework and avoiding the US's increasing heavy-handed influence in the IADB. While the CAF's borrower-only membership freed it of the political influence of wealthy countries, it also imposed serious limitations on raising resources. International capital markets showed no interest whatsoever in investing in the CAF, and bilateral/multilateral sources were also wary, seeing little upside to supporting an MDB over which they would have no influence. Hence the CAF was forced to rely on resources raised from within member countries, which was of limited value to balance of payments-challenged Andean nations. As with IADB, the CAF found it could only access trade financing, and then only in limited quantities.

The CAF's first real efforts to reorient operational policy toward a more viable model in the early 1980s coincided with the advent of the debt crisis in Latin America, hitting its ability to both borrow and lend. Nonetheless the reforms of the 1980s did slowly turn the organization around, as it began to build a new image of financial probity that would open up access to new financing. Shareholders agreed to significantly broaden lending policy, dispensing with the obligation to seek projects related to integration. A concerted effort to build net income, which management was able to retain as reserves and accumulated income, provided a critical financial cushion to reassure would-be investors. Another key characteristic that would catch the eye of investors was the CAF's perfect repayment record—a direct result of the fact that it was entirely controlled by the very same countries it lent to.

The hard work of the 1980s combined with the arrival of President García in 1991 paid off in early 1990s, leading the ratings agencies in 1993 to grant the CAF investment grade status, a better ranking than any of its member countries. By then, the CAF had—like the IADB in the 1970s—opened its membership to countries from outside its original region, with the specific intention of increasing access to resources and improving its financial stability but while still maintaining final authority among its founding members due to the share structure. The investment grade rating and support of new members directly led to the tremendous growth of CAF borrowing and lending that began in the early 1990s and has continued to the present. Crucially for the subsequent chapters of this thesis, however, the CAF—unlike the IADB—made the decision not to seek out industrialized non-borrower countries, which would have eased its market access but at the cost of diluting the political control of borrowers.

By 1994, the CAF's initial parochial vision had given way to a much more open operational style designed to access private markets around the world and to provide whatever financial services its clientele required. Its original vision was simply unworkable, both in the projects it sought to lend to and in its strategy to raise resources. Rather than go out of business, the CAF undertook the reforms it needed to survive and thrive, moving it much closer to the financial model of the World Bank and IADB. Within this broader convergence due to financial pressures, though, the CAF's unique membership structure permitted greater divergence than between the World Bank and IADB. Because it was created only by borrowing countries, the CAF's limitations in accessing capital markets were to a degree offset—after the reforms of the 1980s and 1990s—by greater flexibility and agility in lending procedures as well as the 100% repayment record that came with being a more egalitarian and cooperative MDB.

2.4 Conclusion

The experiences of the World Bank, IADB and CAF over the course of their creation and early years of operations sketched out in this chapter provide compelling evidence that political, economic and financial pressures combined to generate a sort of "ideal" financial-operational model for multilateral development banks, to which each of the three MDBs eventually conformed despite the original intentions of their creators. The reality that governments would not be willing to supply large amounts of budgetary resources for the MDBs to intermediate pushed all three to rely increasingly on private capital markets to raise resources. The perceptions and exigencies of bond buyers, in turn, pushed the MDBs to modify their operational procedures and even basic shareholding structure with the specific aim of securing a reliable source of funding.

Of the three, the World Bank moved most quickly and decisively to incorporate market-based criteria into its operations. This was due in part to the lack of any other options when it began operations, in light of the unwillingness of any shareholder except the U.S. to allow their capital contribution to be used, as well as the pressing need for resources in post-war Europe. By the time the Marshall Plan eased the pressure to lend, the Wall Street ethos was firmly in control, offering loans only to the most creditworthy borrowers for projects expected to generate cash returns in the short term. It was not until the late 1950s, flush with cash and facing growing complaints to lend more, that this organizational culture was diluted to a degree with the creation of IDA. Even this step back toward the development style intended for the World Bank by its New Deal founders was limited, and concerns of financial rectitude remained a high priority.

The early trajectory of the IADB shows clearly that an MDB does not in theory require such strong subservience to the whims of potential bondholders, as long as it enjoys strong financial backing from one or more governments. Generous U.S. contributions of concessional resources allowed the IADB to take a different approach to development lending, one the emphasized lending much more in alignment with the priorities of borrowing countries, and with a less heavy-handed approach to issues like a country's macroeconomic policy. Once this U.S. support waned in the late 1960s, the IADB radically reoriented its operations and very structure to ensure the resources it needed to continue serving as a lender and to keep U.S. policy pressure at arm's length. By switching the types of projects it supported to a profile much closer to the World Bank, and also opening up its membership to countries from Europe and Japan, the IADB secured a dramatic increase in available financing, at the cost of its original vision for the kind of MDB it would be.

The CAF's evolution demonstrates the same point, but from a different angle. Its founders intended to differentiate their operations also, but apparently thought they could do so without any wealthy country backing it. The CAF eventually realized, however, that while having only borrowing countries as shareholders offered a notable degree of operational flexibility, finding financing to intermediate from outside its members was another question altogether. Thus by the 1980s it, too, had turned its focus to what it needed to do to gain access to greater external sources of finance. This meant reshaping policies on lending, rigorously building up net income and reserves (at the expense of offering less expensive loans to borrowers in the short term), and beginning the process of opening membership to other countries. As with the IADB, the original vision of an inward-looking sub-regional bank with limited membership concentrating on specific types of projects was left by the wayside when that model proved ineffective, although in the case of the CAF this did not mean giving up control of the organization by borrower countries.

Different combinations of shareholders can and does shape the trajectory an MDB might take, from its initial creation—thus providing evidence in support of Hypothesis 1. Each of the three MDBs analyzed here were created with different specific purposes in mind that obeyed the interests of their shareholders, and as such they initially developed differing operating styles and policies. However, that same combination of shareholders and their evolving interests also placed important restrictions on the ability of each MDB to secure the resources it needed to operate. The experiences of the World Bank, IADB and CAF outlined here suggest that whatever the composition of their shareholders, only with major financial support from a wealthy nation or nations is there a possibility of establishing a different kind of MDB from the ones we see today. In the absence of that support, MDBs of necessity must access private financial markets to raise the resources they need to effectively operate. This is in fact one of the great strengths of the MDB model: it is to a large degree self-financing, requiring very little direct fiscal contributions from member countries. The flip side, however, is that it also requires MDBs to keep a very close eye on the whims of private capital markets when shaping their operational and financial policies—compelling evidence in support of Hypothesis 3. At the same time, these organizations are guided by the mission of promoting "development"—a fundamentally political mission. Needless to say, these two sets of priorities do not always sit easily with one another, and the experiences outlined in this chapter suggest that financial considerations usually have the last word.

3 LENDING TRENDS BY MULTILATERAL DEVELOPMENT BANKS IN LATIN AMERICA, 1991-2010

The main goal of this thesis is to analyze how different compositions of shareholder power in a multilateral development bank (MDB) can influence its organizational characteristics, which in turn can shape demand for loans on the part of borrower countries. The intuition is that demand-side considerations are increasingly relevant in a global context characterized by growing economic strength of many developing countries once highly dependent on MDBs. Many developing country economies such as China, India, Indonesia, Brazil, Mexico and Peru now have stronger fiscal accounts, low public debt levels, high international reserves and well-established access to international capital markets. One would imagine that demand considerations—rather than supply-side issues that have heretofore dominated the academic literature on MDB activities—are much more important for countries like these than in past years.

This chapter utilizes the theoretical framework developed in Chapter 1, suggesting that differences in lending commitments demanded by MDBs borrowers may be partly explained by the balance of power between borrowing and non-borrowing shareholders (Hypotheses 1 and 2). This governance structure influences the terms of the loans—i.e., financial cost and required bureaucratic procedures. Depending on economic conditions, borrowing countries will put different weights on these factors. Lending commitments—the dependent variable of interest in the analysis—is hypothesized to vary systematically as a function of both: prevailing economic conditions among borrowers and the type of shareholding arrangement in each MDB (and hence its operational characteristics).

The World Bank, IADB and CAF each represent a different breakdown between borrowing and non-borrowing shareholders. The World Bank is controlled by wealthy non-borrowing countries (63.1% of voting shares controlled by non-borrowers in 2010), the IADB has more influence by borrowing countries but is still ultimately under the final control of non-borrowers (50.02% of votes controlled by borrowers, but the U.S. with veto power over capital increases, membership and changes to the Articles of Agreement), and the CAF is controlled by the same countries that borrow from it (97.1% voting shares controlled by borrower countries).

The chapter is examines lending commitments by each of the three MDBs for a common set of borrowing countries in Latin America during the period 1991 to 2010, using a multivariate, large-N analysis in a panel framework with observations across the different borrowers and over time. Based on seemingly unrelated regression estimation (SURE), the coefficient estimates of the different MDB regressions are compared to test the hypotheses on systematic differences between the three cases. [28]

The comparison of only three cases cannot prove a causal relationship between MDB governance structures, borrower preferences and lending, nor can it fully disentangle supply from demand side factors. However, it can test whether the lending patterns observed are consistent with what the theoretical discussion leads one to expect. The aim is to demonstrate that a demand-oriented interpretation of MDB lending is at least as plausible as the supply-side analysis prevalent in the current literature. The causal link between shareholder arrangements and a number of key MDB characteristics, as well as the link between these characteristics and borrower demand, will then be examined in the subsequent three chapters.

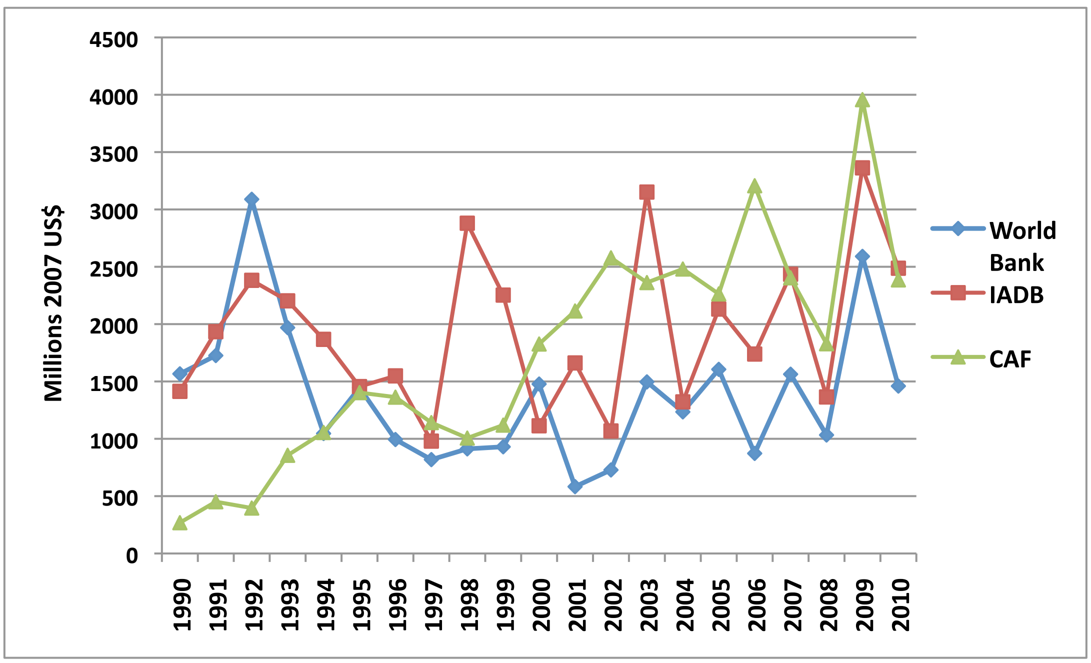
The chapter is organized as follows. Section 3.1 describes the empirical puzzle, while Section 3.2 discusses the hypotheses to be tested. Section 3.3 provides the econometric analysis of lending commitments by the World Bank, IADB and CAF in five Latin American countries, and Section 3.4 concludes.

[28] The theoretical design, case choice and data gathering in this chapter were done entirely by the thesis author, while the multivariate regression design was led by Dr. Katharina Michaelowa of the University of Zurich. Interpretation of the statistical results was done by both the author and Dr. Michaelowa.

3.1 Empirical Puzzle

Before moving on to analyze what might be driving variation in lending patterns by different MDBs over time, it is useful to first consider whether this is something worth explaining at all. It could be that lending remains relatively constant or that it moves in ways that are predictable and easily explained. As can be seen in the figure below, this is clearly not the case, at least for lending by the three MDBs discussed here in five Latin American countries. Annual lending commitments fluctuate widely year by year for each of the MDBs.

Figure 3.1. Annual Lending Commitments by World Bank, IADB and CAF to Five Andean Countries, 1990-2010



Source: Annual Reports of World Bank, IADB and CAF, 1980-2009.
Note: Five countries are Bolivia, Colombia, Ecuador, Peru and Venezuela.

How is one to explain these patterns? Why do the lending commitments of all three MDBs fluctuate so markedly? Why since the early 1990s has the regional IADB lent consistently more than the global World Bank? Why has lending by the relatively little-known CAF grown so dramatically, to the point where it lent more than either the World Bank or IADB in the last decade? As discussed in more detail in the introductory chapter, existing academic research seeking explanations for MDB lending trends have focused almost entirely on the supply side of the equation. That is, studies have almost entirely considered the question from the point of view of why the MDB may or may not offer a loan, with explanations ranging from realist considerations of power politics and donor interest (Harrigan et al., 2006; Dreher et al., 2009a, 2009b and 2010; Babb, 2009; and Kilby, 2006 and 2011, among many others), a rationalist focus on incentives among main actors in MDB activities (Mosley et al., 1995; Gutner, 2005; Vaubel, 2006), or more sociology-based constructivist interpretations of norms and staff self-image (Barnett and Finnemore, 1999 and 2004; Babb, 2003; Woods, 2006; and Weaver, 2008).

In light of the spectacular growth of many large developing countries in recent years as well as the explosion of international capital flows, explanations of MDB lending that ignore demand seems unlikely to be realistic now. Countries that have been major borrowers from MDBs in the past have in recent years found themselves in much stronger fiscal positions and also with a great many options for sovereign borrowing, often at very low interest rates and in domestic currencies. MDBs still offer these countries resources generally at better financial terms than they can get from the markets, but the loans also come with a variety of strings attached that these countries may object to. Hence, a more realistic and complete picture of how MDBs function in the current global economic context requires understanding the role played by borrower demand. This chapter builds a series of hypotheses based on this perception, and attempts to test them with statistical methods.

3.2 Hypotheses

This section summarizes the link between shareholder composition and the characteristics of MDB loans of interest to borrowers, and uses it to build testable hypotheses. The overriding premise is that factors associated with MDB loans combine to form a total "price" faced by borrowers for MDB loans, which includes both financial costs as well as bureaucratic hassles. The assumption driving the hypotheses is that borrowers prefer this "price" to be as low as possible. Based on the link between shareholder power and these operational characteristics—which will be explored in more detail in subsequent chapters—the hypotheses are formulated.

Because the World Bank is dominated by non-borrowing industrialized countries, it can access capital markets at highly favorable terms for its bonds, and hence has a steady stream of lendable capital at terms well below what many borrowing countries normally get on private markets. At the same time, non-borrowing countries impose more onerous project oversight requirements as well as multiple layers of bureaucracy and slow loan approval time. These non-financial aspects to World Bank loans are, on the whole, unappealing to borrowing countries, and can outweigh the low financial cost, notably when countries' alternatives for sovereign financing increase and when their borrowing needs decrease. For Latin American countries that, on average, tended to have increasing access to alternative sources of finance from 1990 onwards, this should lead to a long-term trend away from World Bank lending. Over and above that long-term trend, during years when a country is doing relatively better they would be even more inclined to move away from the World Bank. The opposite should be true during years when they are in a relatively more constrained situation. When a crisis becomes global, tight international capital markets and reduced country access to private financing should further strengthen the attractiveness of the World Bank due to its unparalleled access to capital markets and the "flight to quality" of bond buyers, which translate into low funding costs and, hence, loan prices.

The borrower-dominated CAF, by contrast, has weaker and more expensive access to capital markets. Hence the financial terms of its loans are less attractive than the World Bank's, especially in a time of economic turbulence. On the other hand, because it is controlled by the very nations it lends to, the CAF has no incentive to impose the safeguards that many borrowers object to in World Bank operations, nor any reason to build up the bureaucratic layers of checks and balances that slow down loan approval. This limited bureaucracy is attractive to borrowing countries, although the higher cost of loans is a drawback. Typically, the stronger the macroeconomic situation in a country, the more important a country will consider the former as compared to the latter. As a result, one can expect that the long-term trend of lending by Latin American countries will move towards the CAF as opposed to the World Bank. Over and above the long-term trend, countries will react year-to-year relatively more in favor of the CAF in better economic situations, and relatively less so in worse situations. In times of crisis, however, CAF borrowing costs on private markets are likely to rise considerably due to its own higher cost of funding, thus reducing the attractiveness of CAF loans. Moreover, in times of crisis, the needs of individual countries may surpass the loan amounts the CAF can provide.

The IADB occupies an intermediate position between the World Bank and the CAF in terms of shareholding structure, with borrowers controlling a slim majority of voting power on individual loan approvals, but with industrialized nations led by the US able to veto any changes to IADB policies and organizational structure. As a result the IADB enjoys some of the same advantages as the World Bank in terms of access to capital markets and low cost, and also some of the disadvantages such as more bureaucratic loan approval procedures and safeguard policies demanded by non-borrowers. However, the greater power of borrowing shareholders as well as the fact that most IADB staff is from the region's political and economic elite, loan preparation and negotiation is smoother and bureaucratic requirements less rigid. Hence, over the long term, the IADB is expected to see lending rise more (or decrease less) than the World Bank. However, it should not rise as much as for the CAF. Similarly, IADB lending is expected to react in between the other two MDBs during short-term yearly fluctuations of a country's economic and financial circumstances. During crisis years, IADB lending should increase more than CAF lending, but less than World Bank lending.

The above discussion can be summarized with the following testable hypotheses:

1. Under conditions of generally positive fiscal and developmental trends in their borrowing countries, as a long-term trend the World Bank (non-borrower dominant MDB) will experience a decline in lending, the CAF (borrower dominant MDB) will experience an increasing trend, and the IADB (more balanced between borrowers and non-borrowers) will find itself in between.

2. Around this longer-term trend, countries will gravitate toward World Bank lending and to a lesser degree the IADB, and away from the CAF, as their circumstances worsen in the short term, and vice versa when short-term conditions improve.
3. In times of global crisis, the World Bank and, to a lesser degree the IADB, will show an increase in lending, while CAF lending will increase less or even decrease.

The theoretical framework introduced here suggests that the demand-side factors outlined above can help explain lending patterns by different MDBs. It is obvious that overall lending patterns will be influenced by both demand and supply. Factors that have frequently been identified as determinants of supply in the existing literature (such as level of development, the interest of industrialized country shareholders and MDB staff preferences) will therefore be controlled for in the econometric analysis. However, even these variables can also be interpreted from a demand-side perspective. This issue is discussed in more detail in Section 3.3.

3.3 Regression Estimation Methodology and Results

To test the above hypotheses, the overall trends of lending by the three different development banks and the reaction of their lending to different economic and capital market conditions need to be compared, controlling for possibly interfering variables. The dependent variable is lending commitments by each of the three MDBs to the five countries of Bolivia, Colombia, Ecuador, Peru and Venezuela for the period 1991-2010.[29]

To test the first hypothesis on the correlation between MDB lending and the long-term economic development in the region (in all its different dimensions), a linear time trend (Year) is introduced. To assess the second hypothesis related to the specific influence of variance in individual economic variables over and above this general trend, measures of

[29] In the literature on international development assistance, disbursements are typically used in studies of aid effectiveness, whereas commitments are used to examine the motives of aid allocation or borrower demand. See Berthélemy 2006 and McGillivray and White 1993 for further discussions of the relative merits of commitments vs. disbursements.

GDP per capita, international reserves and investor rankings are utilized. GDP per capita and reserves are intended to proxy how badly a country might need external resources or not, and the investor index gives a sense for a country's access to private capital markets to fill those needs (alternative supply). For the latter, the Institutional Investor index of sovereign risk is used, which is also employed by Ratha, 2005 and Knack et al., 2012 for similar purposes.[30] A separate indicator variable for the global crises in 1997/98 and in 2009 is included, with the aim of verifying the impact of global capital market tightening as described in the third hypothesis.

Control variables include the inflation rate as a measure of economic governance, and the number of (relevant) votes along with the US in the UN General Assembly for political closeness to the largest shareholder in the World Bank and the IADB. In the existing literature, such variables reflecting the governments' general political stance as well as their economic policies have frequently been shown to influence MDB lending (Thacker, 1999, Burnside and Dollar, 2000, Dollar and Levin, 2004, Dreher et al., 2009a and 2009b, and Kilby 2006, 2010 and 2011, among others). IMF lending is also included as an alternative source of funding,[31] and the countries' population as a simple scaling factor. All variables and data sources are described in Table 3.1.

[30] An indicator tracking the interest rate faced by a government would be ideal here, but this would involve finding out the interest rate a government *would have had* to pay to borrow from private markets, for both bonds and bank loans. This counter-factual cannot be realistically constructed.

[31] In an experimental version of this model, bilateral lending was also included. However, it had no significance, nor did its inclusion affect the other variable results. As such it was left out of the final version.

Table 3.1. Variable Description and Sources

Variable Name	Description	Source
World Bank lending	Annual World Bank sovereign lending commitments in each fiscal year, in millions of const. 2007 US$. In the single case of Bolivia, this variable includes a limited amount of IDA lending. No other country received IDA lending during the period under review.	World Bank, 1990-2010
IADB lending	Annual IADB sovereign lending commitments in each fiscal year, in millions of const. 2007 US$. Includes both non-concessional (OC) and concessional (FSO) loans, although OC lending is much higher in all countries except Bolivia for the entire period.	IADB, 1990-2010
CAF lending	Annual CAF sovereign lending commitments in each fiscal year, in millions of const. 2007 US$.	CAF, 1990-2010; CAF 2009a for sovereign vs. non-sovereign split in the early part of the period
Year	1991, …, 2010 (linear trend)	
Investor ranking	Ranking on the semi-annual Institutional Investor index of investor sentiment.	Institutional Investor, 1990-2010
Reserves (% of ext. debt)	Total international reserves (minus gold) as % of public and publicly guaranteed external debt service.	World Bank, 2012a
GDP per capita	GDP per capita in 2007 international $, PPP	World Bank, 2012b
Global crisis	Dummy = 1 for the years 1998/99 (Asia, Russia and Brazil capital markets crises) and 2009 (global financial crisis)	
UN voting with US	Number of votes in the UN General Assembly designated as important by the US State Department in support of the US position, plus ½ the number of abstentions, divided by the total number of votes in the UN General Assembly designated as important by the US State Department. This follows the methodology of Thacker, 1999.	Database of votes provided by Dreher for 1983-2008, as used in the papers by Dreher et al. 2009a and 2009b; US State Department 2012 for 2009 and 2010 data
Inflation (%)	Inflation in annual % (national consumer price index)	World Bank, 2012b
IMF lending (mio)	IMF disbursements in calendar year, 2007 US$	World Bank, 2012a
Population (mio)	Absolute numbers	World Bank, 2012b

It must be acknowledged at the outset that the variables included in our empirical model can a priori reflect supply and demand side considerations. In fact, previous studies advancing only supply side arguments face exactly the same dilemma, but this tends to be overlooked and is usually not even mentioned. To address the issue explicitly, both perspectives are presented in Table 3.2, with the coefficient signs that each interpretation would predict. For all relevant explanatory variables, the sign of the estimated coefficient indicates whether the demand or supply perspective is more plausible. [32]

For example, the hypotheses predict a negative correlation between reserves and World Bank lending in a given year, due to the country demanding less World Bank loans. However, from a supply side perspective, the World Bank could be expected to increase the loan offer because the country is a more attractive low-risk borrower. For poor African countries, an alternative, need-driven supply argument may be plausible, but none of the interviews undertaken for this thesis and other existing information from within the MDBs suggests that this would be the case for the middle-income countries and years in the sample. Since the early 1990s, the World Bank has produced numerous strategy reports and undertaken various procedural reforms specifically for the purpose of maintaining lending relationships with wealthier middle-income countries, which the World Bank fears no longer want to work with them. This includes the middle-income country assessments and strategies (World Bank, 2001a, 2004a and 2007a), studies on the costs of safeguard policies (World Bank, 2001b and 2010a), the country systems pilot (World Bank, 2005a), investment lending reform (World Bank, 2009a) and the recent Program for Results instrument (World Bank, 2011a). The drive to continue lending to wealthier borrowers—in part to protect the quality of the loan portfolio—is also noted by Knack et al. (2012, p. 171).

[32] An ideal variable to better disentangle supply from demand effects would be the amount each MDB would have been willing to lend to each country for each year—while this information does exist, it is unfortunately not publicly available.

Table 3.2. Variables and Expected Impact: Demand vs. Supply

Variable	Demand-side interpretation	Supply-side interpretation
Year (linear trend capturing general economic development)	Countries become economically and financially more self-reliant and have less need for funding from development banks. Because of the differences in bureaucratic hassle factor (World Bank most, CAF least, IADB between), the **World Bank should be clearly on a negative trend (–), the CAF positive (+); IADB in between (+/–).**	Countries become safer borrowers. This increases the willingness to lend for all banks, or at the least maintains steady trends due to need to generate loan income based on MDB financial model. → **Expected coefficient: + or flat** [An alternative interpretation that would predict the opposite sign suggests that MDBs may prefer to supply to economically needy countries. However, substantial evidence from documents and interviews clearly contradicts this view (see also Knack et al. 2012, p. 171), particularly in middle-income countries such as those in the sample]
Investor ranking (financial situation as perceived by investors)	As above.	As above.
Reserves (% ext. debt) (debt sustainability)	As above.	As above.
GDP per capita (economic situation)	As above.	As above.
Global crisis (global financial downturn)	Countries have greater demand for MDB loans due to tight international capital markets. However, CAF lending becomes more expensive as compared to IADB and World Bank lending because of a greater difference in funding costs in a crisis. Thus, **World Bank and IADB lending should go up (+), CAF lending should go up less or decrease (+/–).**	Banks attempt to stabilize the financial situation. However, since the crises are global, the World Bank as a global bank may have other priorities than lending to Latin America. In this case the coefficient for the **World Bank might not be clear (+/–). CAF also unclear (+/-)** because it may face restrictions in access to capital markets because of its lower rating, and hence may be forced to restrict loan supply; **IADB lending should increase (+)** as it has a regional role to fulfill and should not be restricted by capital markets due to AAA rating**.**
UN voting with US (political closeness to US)	Banks are more attractive lenders for countries that share their main policy orientation. **Expected coefficient for World Bank (+), for CAF (–) and for IADB in between (+/–).**	Borrowers are more attractive for banks that share their main policy orientation. **Expected coefficient for World Bank (+), for CAF (–) and for IADB in between (+/–).**
Inflation (%) (bad economic governance from World Bank perspective)	Governments with high inflation rates will avoid the World Bank, which would interfere with their economic policy choices. The same might be true for the IADB, but is certainly not true for the CAF. **Expected coefficient for World Bank (–), while for CAF lending should not be affected (+/–). IADB in between (+/-).**	World Bank will lend less to governments with high inflation rates, which indicate non-orthodox economic policies. The same might be true for the IADB, but is certainly not true for the CAF. **Expected coefficient for World Bank (–), while for CAF lending should not be affected (+/–). IADB in between (+/-).**
IMF lending	IMF lending could reflect situations of greater need, but also the existence of alternative funding to satisfy given needs. **Expected effect unclear**.	IMF lending could reflect situations of greater need, but also the existence of alternative funding to satisfy given needs. **Expected effect unclear.**
Population	Higher number of inhabitants increases the demand for funding. **Expected effect (+)**	Higher number of inhabitants increases the supply of funding as a response to need, but also because large countries are typically politically important. **Expected effect (+)**

The design of the model—looking at the comparisons between the impact of relevant explanatory variables the lending of three different MDBs (rather than just one)—further helps bring out these demand effects more clearly.

While the coefficients for economic variables will give more or less plausibility to either the demand or the supply side arguments, the situation is more difficult to interpret for policy variables. A country that is politically opposed to the US may either prefer to borrow from the CAF, or otherwise, the World Bank and the IADB may be more reluctant to lend. For example, Ecuador has not borrowed from the World Bank since 2009. Many existing studies would interpret a correlation between Ecuador's U.N. voting against the U.S. and no lending as a sign of U.S. influence at the World Bank. However, interviews with Ecuadoran government officials and World Bank staff in the Ecuador office (discussed in Chapter 6) make it clear that in fact the World Bank would like to re-start lending, but the country prefers not to take out loans for its own political reasons. Since the distinction is impossible to ascertain in a statistical framework, we use these variables only as controls.

Conceptually, the argumentation is based on the idea that for any Latin American country, borrowing from the World Bank, the CAF and/or the IADB must be considered as joint decisions, because these banks operate in a common market. This has consequences for the choice of regression model. If lending by different MDBs is not determined independently from each other, this information can be taken into account to obtain more efficient regression estimates. Therefore this chapter uses seemingly unrelated regression estimation (SURE) that allows error terms to be correlated across equations. In addition, SURE is convenient to compare the three individual MDB cases, which is necessary to examine the role of the three governance types. This is accomplished by testing the differences in the coefficients for the different MDB regressions using (one-sided) Wald tests.

The first three columns in Table 3.3 show the SURE regressions using (1) World Bank lending, (2) IADB lending, and (3) CAF lending as the dependent variables. The remaining three columns show the differences in the coefficients for the different banks and the significance of these differences according to the Wald tests.

The first line, for the linear trend, provides partial support for the hypothesis related to long-term trends in lending choices. On average over the 20-year period and the five countries considered, and at given levels of the other variables, World Bank lending has declined by 11 million USD per year, IADB lending has declined by 21 million, and CAF lending has increased by 20 million. These effects are statistically significant for IADB and CAF. The coefficient for IADB was hypothesized to be greater (more positive) than for World Bank, and that the CAF's should be greater than for both other banks. The difference in the coefficients for World Bank and IADB indicates a stronger (here: less negative) time trend for World Bank, but this unexpected result is non-significant (column 4). Conversely, and as expected, the CAF shows a significantly more positive time trend than either the World Bank (column 5) or the IADB (column 6).

These results indicate that over time, along with the overall growth and stabilization of Latin American economies, CAF lending increased steadily, while World Bank lending declined. The even stronger negative trend observed for the IADB was unexpected both theoretically and based on the graphical illustration in Figure 3.1, which suggests a similar trend between the two MDBs. This implies that the development represented in the graph is partially driven by some of the other variables. In any case, from Figure 3.1 it is evident that the absolute level of IADB lending remained above World Bank lending throughout the period, apart from three years. In fact by 1991 the IADB was already lending more in absolute terms than the World Bank, which could indicate that the dynamics behind the first hypothesis may have already played out before the time period analyzed here in relation to the IADB vis a vis the World Bank. Alternatively, it could be that the differences in loan approval procedures and safeguards between the World Bank and IADB are too marginal from the point of view of the borrower to make much of a difference between the two MDBs, compared to the far more borrower-friendly procedures at the CAF.

Table 3.3. Determinants of Lending and Differences Between MDBs, 1991-2010

Coefficients for Method: SURE	(1) World Bank lending (mio USD)	(2) IADB lending (mio USD)	(3) CAF lending (mio USD)	(2) - (1) Difference IADB-World Bank	(3) - (1) Difference CAF-World Bank	(3) - (2) Difference CAF-IADB
Year	-10.88	-21.13*	20.38**	-10.25	31.26**	41.51***
	(0.19)	(0.09)	(0.05)	(0.30)	(0.02)	(0.00)
Investor ranking	-19.87*	-12.89**	7.62***	6.98	27.49**	20.51***
	(0.10)	(0.04)	(0.00)	(0.32)	(0.02)	(0.00)
Reserves (% ext. debt)	7.90*	1.00	-5.56**	-6.90**	-13.45**	-6.56
	(0.09)	(0.81)	(0.03)	(0.01)	(0.02)	(0.15)
GDP per capita	0.19*	0.18***	-0.04	-0.01	-0.23***	-0.22***
	(0.06)	(0.00)	(0.26)	(0.47)	(0.00)	(0.00)
Global crisis	-167.08**	113.83*	-119.89***	280.92***	47.19	-233.72***
	(0.02)	(0.09)	(0.00)	(0.01)	(0.25)	(0.00)
UN voting with US (share)	672.17***	-177.64	-44.91	-849.81*	-717.09**	132.72
	(0.01)	(0.67)	(0.87)	(0.05)	(0.04)	(0.37)
Inflation (%)	-0.07***	0.05***	0.03***	0.12***	0.10***	-0.02***
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.01)
IMF lending (mio USD)	0.04	0.04	-0.04	0.00	-0.08	-0.08***
	(0.50)	(0.54)	(0.55)	(0.49)	(0.25)	(0.00)
Population (mio)	57.72**	50.11***	11.79	-7.62	-45.94**	-38.32**
	(0.02)	(0.00)	(0.26)	(0.39)	(0.03)	(0.01)

Notes: Robust p-values in parentheses. For differences, they are calculated testing one-sided hypotheses using Wald tests (*** $p<0.01$, ** $p<0.05$, * $p<0.1$). Country fixed effects are included but not shown. All right-hand-side variables except “Year” are lagged by one year. There are 100 observations (5 countries x 20 years) in each regression. R^2 (within) for each of the regressions individually is 25%(1), 15%(2) 45%(3).

Over and above the general trend, the specific economic variables related to the second hypothesis show the expected results for the investor index. A one point increase on the investors’ ranking scale (0-100) leads to a 20 million USD decrease in World Bank and a 13 million decrease in IADB lending. At the same time, it leads to an 8 million increase in CAF lending. As with the linear trend, the differences in coefficients between the CAF and the other two banks have the expected sign and are strongly significant. These outcomes are very difficult to reconcile with a supply-side perspective. They clearly indicate a preference for the CAF whenever a country is rated highly so that it has a generally better access to the capital market. While the difference between World Bank and IADB now also points in the expected direction (IADB taking up an intermediate position between World Bank and CAF), it is again non-significant (column 4).

The other economic variables (GDP per capita and reserves) do not show the expected results. To some extent, this may be due to the multicollinearity between the different variables.[33] When taking out the time trend and the investors' ranking, neither GDP per capita nor reserves are significant for the lending of any of the three banks. When only the investors' ranking is entered, the positively significant reaction of CAF remains unchanged. This implies that access to the capital market matters most for the demand-side arguments. The more traditional economic indicators fail to show the expected effect—at least as long as individual country fixed-effects (FE) are controlled for.[34]

The effect of the global crises variable also shows some unexpected features. Ceteris paribus, the effect of a global crisis reduces rather than increases World Bank lending, by an average amount of 167 million USD. This can only be interpreted as a supply restriction, given that the World Bank as a global player faced simultaneous demands from all parts of the world during these situations. This was particularly true during the 1998/99 crisis (see Figure 3.1), when the World Bank apparently focused more on lending to the hard-hit Asian economies. The IADB as a regional development bank shows the expected significant and positive coefficient, indicating that as a regional MDB it stepped in to fill the gap left by the World Bank's supply restrictions. While the CAF is also a regional MDB, its own cost of funding would have spiked during the crisis (it is negatively impacted during capital market tightening, unlike the other two MDBs, as will be discussed in Chapter 4), explaining the negative coefficient. This is in line with the hypothesis that in times of economic crisis, countries shift their demand towards MDBs with lower lending cost.

Coefficients for the political control variables correspond to the typical findings in the literature, which enhances confidence in the correct specification of the model overall. UN voting along with the US significantly increases the average loan volume extended by the World Bank (as found by Anderson, et al. 2005 and Dreher et al. 2009a) while it is insignificant for the IADB (as found by Bland and Kilby, 2012). The large coefficient for the World Bank refers to the hypothetical situation that a country that never voted along

[33] The bivariate correlation coefficients between any two of these variables except GDP per capita and reserves are above 20%, between the investors' ranking and GDP per capita, it is as high as 55%.
[34] Given the results of a Hausman test, the inclusion of FE is clearly indicated, and RE-estimation is biased. See Annex 1, Table A1.1, for a comparison with a random effects regression (Regression 1).

with the US then always votes with the US. The coefficient indicates that, on average, a country that increases the share of its votes along with the US by 10 percentage points would receive 67 million USD more in World Bank loans. As with the IADB, the coefficient is not significant for the CAF; and both regional development banks differ significantly from the World Bank but not among themselves. Similarly, only World Bank lending reacts negatively to higher inflation, but the positive reaction of both the IADB and CAF suggests a possible substitution effect—although as stated previously whether this is driven by supply or demand considerations is not clear. Regardless, even though differences between the MDBs related to inflation are significant, the coefficients are very small, implying that the impact of this policy variable is minimal (at least at the relatively low inflation levels prevalent during the period under analysis).

The control for alternative funding by the IMF is insignificant throughout, possibly due to mutually offsetting effects (e.g., IMF funding could show the need for resources, but also that existing needs are being covered from this alternative source). At the same time, the control for population appears important, at least for the World Bank and the IADB, although country FE should already capture the bulk of the variance in population size.

Robustness of these results was checked in a variety of ways. Annex 1, Table A1.1 presents some alternative specifications using per capita lending rather than the absolute volume of lending, using tobit regressions, and using a specification in logs. To save space, joint regressions were used across all three banks (with MDB-specific country effects) rather than SURE regression, and interaction terms are specified for all variables with an IADB and a CAF dummy respectively. While this does not provide a significance test for all differences between the three banks, it shows whether and to what extent IADB and CAF lending reacts differently from World Bank lending. Results of regressions that appear most convincing in econometric terms do confirm the results, and differences between the specifications find plausible explanations. Annex 1 provides a detailed account of the regressions presented, discusses the pros and cons of each specification and compares the results. Serial correlation was also tested using a Wooldrige and a Baltagi-Li test, and no evidence was found whatsoever.[35]

All in all, results appear relatively robust and point to a significant role of demand-side factors playing out in different ways for the three banks, in line with the theoretical arguments on their governance structures. Of course, as an initial explorative analysis, this study had to concentrate on a clearly defined region and period, and thus a limited number of relevant banks. To ascertain if the same dynamics hold true in other regions of the world and with other MDBs, it would be necessary to expand the analysis. This would also mitigate the problem of just including a single case for each of the three governance structures. While an extension to other MDBs is beyond the scope of this paper, it should be possible to use this classification for further research testing the external validity of our results.

3.4 Conclusion

This chapter statistically tested two novel theoretical considerations regarding multilateral development banks (MDBs). First, MDBs respond not only to supply factors such as geopolitical considerations of major shareholders, bureaucratic pathologies or development ideologies, but also to the evolving demand of their client borrowing countries. Hence the traditional supply-side perspective adopted to analyze MDB lending can be usefully augmented by demand side considerations—all the more so in recent years as the alternatives for sovereign borrowing have grown tremendously for many developing countries. Second, demand for loans depends, among other things, on the governance structures of the MDBs, notably on the balance of power between their borrowing and non-borrowing shareholders, and the implications of this governance structure for loan cost and bureaucratic procedures. Borrowers weigh these factors

[35] As further alternative to these specifications, using the Libor-based loan rates directly as additional explanatory variables would be useful. However, a reliable time series could not be constructed because of comparability issues between loans offered by different MDBs in different time periods, as well as data shortcomings. As a test, a new variable was constructed by taking the difference between the CAF and the IBRD Libor rates, and it is positively and significantly correlated to IBRD lending (i.e. the higher the price of the CAF, the higher IBRD lending), and this effect reduces the effect of the general trend (year). Overall, this is consistent with our expectations. See Chapter 4 and Annex 2 for a more detailed discussion of MDB loan financial terms.

differently depending on economic circumstances, so that the relationship between economic conditions and lending can be used to (indirectly) assess the link between MDB governance structures and demand for lending.

These issues are investigated by comparing three MDBs with different governance structures: (i) domination by non-borrowers (World Bank), (ii) domination by borrowers (CAF), and (iii) more balanced control by both borrowers and non-borrowers (IADB). Lending by each of these MDBs is examined for a common set of borrowing countries in Latin America from 1991 to 2010. Multivariate econometric analysis suggests that indeed, lending in response to different economic situations differs considerably among the three banks. Over time, along with the overall growth and stabilization of Latin American economies, CAF lending increased steadily, while World Bank lending declined. The IADB's trend was also negative, which was unexpected, but the absolute level of lending has nonetheless remained consistently above the World Bank's through the period (see Figure 3.1).

Over and above that general trend, countries are even more inclined to opt for CAF lending and less to the World Bank, with the IADB in between, when in relatively good economic conditions, as proxied by their access to private capital markets. This alternative supply variable turned out to be more important for countries than proxy variables for country need (reserves and GDP per capita).

During times of global capital market crises, the effect on World Bank lending was overall negative, also an unexpected result, while it was positive for the IADB and negative for the CAF. These results are likely more driven by supply-side considerations, especially the fact that the World Bank may face credit rationing and need to allocate more loans to other parts of the world, while the regional IADB will "pick up the slack" and ramp up lending to Latin America. The CAF, by contrast, is negatively affected by capital market tightening due to its lower credit ranking, and hence its cost of funding will rise, which would be unattractive to borrower countries.

These results are generally in line with the theoretical expectation that the non-borrower dominant governance structure of the World Bank, and the bureaucratic and policy stipulations that come along with this structure, lead countries to seek alternative creditors. These alternatives are easier to find when the countries' economy is in good shape, particularly when it is perceived to be so by private capital markets. During global economic crisis, however, MDBs with large industrialized countries as major shareholders can make use of their better access to private financial markets and ensure lending at much better rates. They are therefore the preferred creditors during such periods—although the World Bank may face supply restrictions due to needs elsewhere because of its global mandate.

Thus, the hypotheses posited at the outset find some support in the empirical evidence analyzed in this chapter. Whether this is in fact driven by the assumptions underpinning the hypotheses—that governance structures shape lending characteristics, which in turn affect country demand—remains an open question. The statistical tests here merely confirmed that this is plausible, but did not establish causal links. Hence, the next two chapters will examine several operational characteristics of MDB lending, and their links to shareholder balance of power, using qualitative research methods, to determine if these causal links do indeed hold true. The subsequent chapter will then examine two country case studies in an effort to ascertain if these MDB characteristics impact loan demand in the ways hypothesized here.

The results of this chapter do not (and were not expected to) reject the notion that supply-side dynamics play a prominent role in shaping MDB lending patterns, and in fact the findings in relation to global crises and policy variables substantiate supply-side impacts. But the evidence indicates that the overwhelming focus on supply-side considerations in the existing literature can and should be usefully supplemented with demand considerations, taking into account the preferences of borrower countries. This is particularly true in light of the changing economic panorama for many middle-income developing countries that have heretofore been among the largest MDB borrowers. Focusing on supply factors may have been a realistic approach to analyzing MDB lending in the 1980s, but the current situation of many large developing countries suggests that demand must be taken into account to better understand the complexities of development lending today.

4 The Politics of Loan Pricing at Multilateral Development Banks

Why do countries borrow from multilateral development banks (MDBs)? One can imagine any number of possible reasons, ranging from access to technical assistance, the use of MDBs to further internal political agendas or a desire to be seen in international financial markets as a "good student" and hence attract investment, among many others. But the most obvious reason is, of course, because MDBs offer loans at more attractive financial terms than borrowing countries could get themselves from other sources. The signature characteristic of MDBs, which has led to the remarkable success of this particular variety of international organization, is that—based on their capital structure and financial track record—MDBs can borrow cheaply on international financial markets, and on-lend resources to borrowing governments at low interest rates with enough margin left over to pay for administrative overhead. Hence, as part of the goal of understanding demand factors in development lending, this chapter considers political economy issues underlying MDB loan pricing. The aim is to ascertain how this critical characteristic of MDB lending for borrower demand may be linked to the differing shareholding structures of the World Bank, IADB and CAF, thus providing evidence relevant to Hypothesis 1.

The chapter is structured as follows. Section 4.1 addresses the impacts of MDB capital structure on access to bond markets. Section 4.2 discusses the incentives behind net income accumulation, and the consequent impact this has on loan pricing. Section 4.3 concludes. Evidence in the chapter comes from several sources: data and documents from the MDBs themselves, interviews with high-level financial officials and executive directors and alternate executive directors (country shareholder representatives)[36] at all three MDBs, interviews and reports from bond rating agencies, and news reports.

[36] The World Bank executive board has 24 "chairs", and all but five of these represent groups of countries. Chairs grouping multiple countries have the executive director from one country, the alternate from another country, and top advisors to the executive director from other countries in the chair. Countries often rotate those positions on a regular basis. The IADB has a similar shareholding representation structure, organized into 14 chairs.

4.1 Why MDB Loan Pricing is Both Important and Puzzling

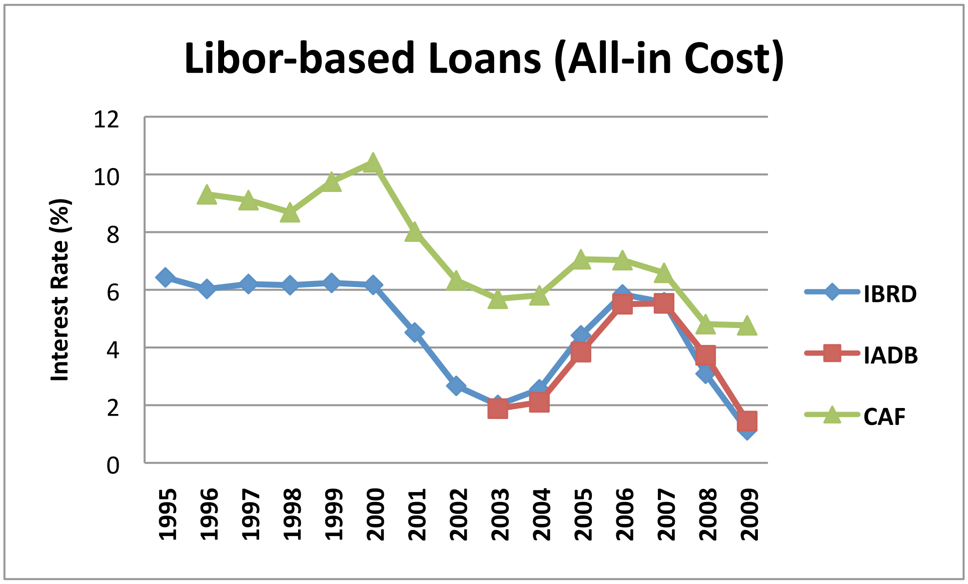
What factors, exactly, lead MDBs to set the price of their loans at a given level? Do those prices vary among different MDBs, and if so, why? Considering that the raison d'être of MDBs is to promote development, one might presume that MDBs pick an optimal price for borrowing countries in light of their abilities to pay, and keep this cost relatively steady to make repayment flows more predictable for developing countries. One might further imagine that MDB loan costs vary between each other mainly as a function of the level of wealth of shareholder countries of each MDB, and hence the perceptions of investors buying MDB bonds. For example, the World Bank—backed by most nations of the world, including all industrialized countries—would logically have cheaper borrowing costs than, for example, the regional Inter-American Development Bank (IADB). Both would in turn borrower more cheaply than the sub-regional Andean Development Corporation (CAF), which is majority-controlled by several Latin American countries.

These assumptions are only partially borne out by the data, as Figures 4.1 and 4.2 reveal. The figures show the "all-in" loan costs offered to borrowing countries in recent years by the World Bank (63% controlled by industrialized non-borrowing country shareholders in 2009), the IADB (voting control split 50.02% borrower and 49.98% non-borrower country shareholders) and the CAF (controlled by borrowing country shareholders).[37] The loan costs of all three MDBs fluctuate markedly over the years, rather than staying at a steady level, and the rates from all three trend in roughly similar directions over time. This suggests that all MDBs face considerable impacts from global capital market movements, and transfer this funding risk to their borrowers by varying the interest rate they charge for their loans. This finding is not entirely surprising, but it has important implications for social scientists in attempting to understand MDB activities—if MDB loan prices rise and fall due to global capital market conditions, that might have a major

[37] Comparing the pricing for different MDB loans is no simple task, due to issues such as the fees charged, type of interest rate offered and maturity profile, among other issues. The figures depict two types of loans that are directly comparable, with the available years for each MDB in question. See Annex 2 for a full discussion of these issues and the methodology behind these figures.

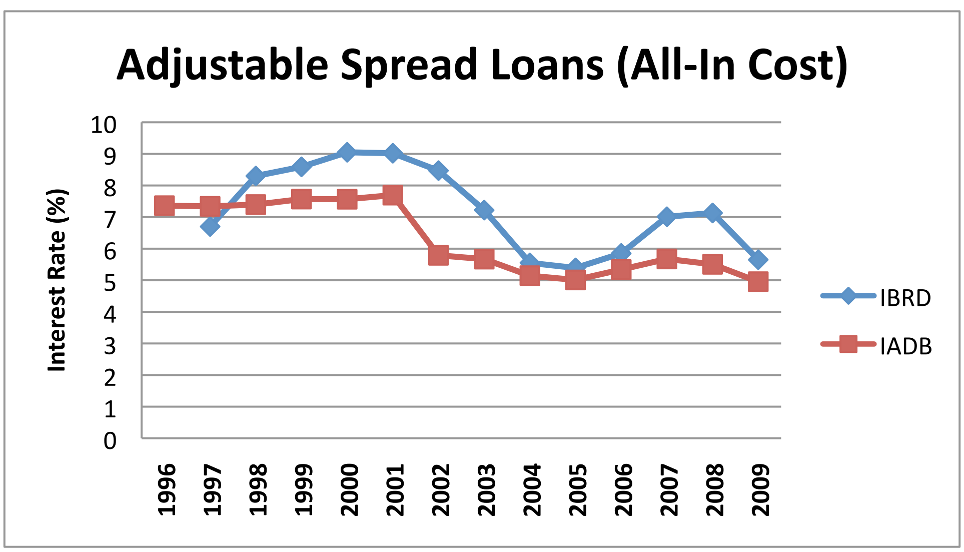
impact on the demand for MDB loans on the part of countries that have other borrowing options.

Figure 4.1. Libor-based Loans (All-in Costs)



Source: Methodology for annualizing fee costs taken from World Bank 2010b. Loan interest rate sources: World Bank, 2011b; IADB, 2011a; and CAF, 2009a. Fee sources: World Bank, 2007b; World Bank, 2011c; IADB 2011b; and CAF 2009a.

Figure 4.2. Adjustable Spread Loans (All-in Costs)



Source: Methodology taken from World Bank 2010b. Loan interest rate sources: World Bank, 2011b and IADB, 2011c. Fee sources: World Bank, 2007b; World Bank, 2011c; and IADB 2011b.

But two other patterns immediately apparent in the figures are more surprising. First, while CAF's loan costs are higher than the other two MDBs, the gap is not as wide as one might expect in light of shareholder composition, and narrowed quite dramatically toward the end of the period. In fact, in 2007 and 2008 CAF loans were priced just marginally above those of the World Bank and IADB—a rather shocking finding, considering the huge wealth gap among country shareholders backing the CAF and the other two MDBs. Second, IADB loans are often slightly cheaper than World Bank loans, especially with the adjustable rate loan instrument, even though the World Bank is obviously a much larger and better-known MDB, with nearly four times the number of country shareholders (48 vs. 186 members, respectively, in 2009).

What explains these curious findings? How is it that the sub-regional CAF is able to offer increasingly competitive loan pricing compared to much larger MDBs backed by the wealthiest countries in the world? And why would the regional IADB offers lower loan prices then the global World Bank? This chapter attempts to answer these questions by utilizing a theoretical framework based on the relative balance of power and interests of borrowing vs. non-borrowing country shareholders at these three MDBs, in keeping with the broader theoretical approach of the thesis. In so doing, the chapter seeks to better understand how shareholder interests shape loan pricing, a key aspect influencing demand for MDB loans on the part of developing countries.

The research is limited to two sets of critical factors shaping loan pricing common to all three MDBs: (i) the ability of each MDB to issue debt on private markets, as related to shareholding structure; and (ii) the uses of and hence incentives for MDBs to generate annual net income. The first factor goes a long way toward determining the cost of funding of each MDB, a key component of its loan price. The second set of factors gets at why each MDB—a non-profit organization—might charge borrowing countries more than might otherwise be the case as a way of generating a certain level of net income each year. This paper explores these issues and their links with the composition of country shareholders within each MDB.

These issues are almost entirely ignored in the academic literature, despite their importance for understanding MDB activities. Countries borrow from MDBs in large part because MDBs are willing to lend them money at attractive interest rates and maturities. Hence, analyzing decision-making process that goes into the financial terms of MDB lending is essential to grasp why they do what they do. However, academic analysis of these financial issues has thus far been limited to a history of the World Bank (Kapur et al., 1997, particularly pp. 905-1118) and two papers on the World Bank's use of net income (Kapur, 2002 and Mohammed, 2004). A former World Bank senior financial advisor has written a little-known (and one suspects, given the paucity of references to it, even less read) book on the financial mechanics of MDBs, but it was intended for development practitioners, and does not consider political economy implications in any detail (Mistry, 1995). Researching the financial cost of MDB loans might deter more politically-inclined researchers, but as this chapter will demonstrate, the finances of MDBs are deeply political. The aim is to determine whether country shareholder composition does in fact influence loan pricing in ways that lead to the patterns seen, and to describe the causal mechanisms.

It should be noted that this chapter considers mainly the non-concessional lending windows of the World Bank and the IADB, for two main reasons. First, concessional lending resources do not come from capital markets and as such issues such as net income generation, financial stability ratios and market perceptions of shareholders do not come into play. Second, concessional lending represents only a small fraction of non-concessional lending by MDBs in Latin America (in 2009, FSO equaled 1.5% of total IADB lending commitments and IDA equaled 1.4% of total World Bank lending commitments in Latin America), and is as a result much less relevant for this research project.[38] As such, for the remainder of this chapter references to "World Bank" and "IADB" refer to the non-concessional lending windows of each, except when specifically noted. The CAF only recently began very limited concessional lending.

[38] A study of MDB activity in Africa or South Asia, by contrast, would necessarily have to take concessional lending into account.

4.2 The Impact of Capital Structure on MDB Borrowing in Global Capital Markets

Unlike most other international organizations, the majority of MDB resources come from borrowing on international capital markets. The fact that MDBs can access international bond markets, use those resources to make loans and cover the bulk of their administrative costs on the margin between borrowing and lending costs—and hence do not require regular budgetary allocations from member governments—has unquestionably been key to the spectacular success of this particular model of international organization. Thus understanding the relationship between MDBs and capital markets is important for a broader understanding of how MDBs function and why they may differ from one another.

The link between shareholder composition and the ability of an MDB to raise resources on private capital markets requires a brief review of an MDB's financial model. Countries reach an agreement to create an MDB, and contribute a certain amount of capital in actual cash ("paid-in capital"). As well, each MDB builds up a level of financial reserves as a result of its operations, which together with paid-in capital comprise the organization's equity, comparable to the equity of any private financial institution. Uniquely, however, MDBs also have a portion of capital that each member country commits as a guarantee should the MDB ever need it, but does not actually pay in cash ("callable capital"). Armed with equity and callable capital, MDBs issue bonds on international capital markets.[39] Thus, the bond rating and the terms at which international capital markets are willing to lend to each MDB depends to a very large degree its capital structure.

A key factor in determining the market's perception of MDB creditworthiness is, in turn, the creditworthiness of the country shareholders providing callable capital. This feature of MDBs originated with the creation of the World Bank. Founding countries were required to pay 20% of their capital commitment in cash, with the remaining 80%

[39] MDBs can and do make private bond placements, for example with central banks, but the vast majority of their funding come from capital markets.

committed as a guarantee that would be called upon should the bank ever require it to pay off their creditors.[40] Every MDB created since has utilized the same mechanism. This callable capital—and the creditworthiness of the governments providing it—acts as a guarantee to private markets that the credit they provide to an MDB is protected and will be paid off, regardless of whether borrowing countries default on their loans from an MDB. As the bond rating agency Fitch noted in a 2010 report laying out their rating criteria for MDBs, "Supranationals' credit quality derives first and foremost from the support of member states…Support to MDBs is granted through 'callable capital'…" (FitchRatings, 2010a, p. 1).

All three major rating agencies only consider callable capital from industrialized non-borrowing countries to be of any real worth, although there is some difference among them in terms of allowing AA or only AAA callable capital to be counted. Callable capital from countries with lower ratings are not counted because, in the words of Standard and Poor's, "At a time of global financial stress sufficient to require an MLI [multilateral lending institution] to issue a capital call, it is unlikely that many of these countries would be able to comply" (Standard and Poor's, 2007, p. 7). According to this criterion, the agencies view the IADB and World Bank essentially the same. For both, the sum of callable capital from highly-rated shareholders and total paid-in capital and reserves are consistently more than 100% of total outstanding loans and guarantees. As Standard and Poor's notes referring to the World Bank, this "implies that the bank would remain solvent even if all of its loans were deemed worthless and it had to pay out under all of its guarantees outstanding" (Standard and Poor's, 2010a, p. 17). Hence both the World Bank and IADB have for decades awarded both the highest bond rating, AAA, despite the fact that borrowing shareholders hold a higher percentage of voting power in the latter. To the markets, the relative voting power of countries is less important than the guaranteed capital from wealthy countries.

[40] The share of callable capital in total capital has grown steadily over the years for both the World Bank and IADB. As of end-2009, callable capital represented about 94% of total World Bank capital and 96% of IADB total capital.

The CAF faces a very different situation. It was first created without any callable capital. Faced with a total inability to access private capital markets, shareholders committed US$200 million in callable capital in 1975. This had no impact whatsoever on inspiring the confidence of bond markets, and when the CAF began to work in earnest on winning the trust of markets it did so through its operations, not callable capital (see Chapter 2). This trend has continued to the present. Unlike the World Bank and IADB, the CAF's paid-in capital (68% of total capital) is now much higher than callable capital (32%). And of the CAF's callable capital, only the US$200 million share of Spain was rated AAA, a rating it lost in 2010 (Standard and Poor's, 2010b). Even though it has financial indicators superior in many respects to the World Bank and IADB, the CAF is currently rated A+ by Standard and Poor's and Fitch, and A1 by Moody's—four steps below the other two—mainly because of the lack of AAA callable capital (FitchRatings, 2009; Standard and Poor's, 2010b; Moody's, 2009). Ratings agencies indicate that further upgrades in CAF's ratings would depend in large part on attaining more creditworthy shareholders.

The CAF has been very clear that it will not take on non-borrowing shareholding countries to any significant degree, because of the implications it would have in changing the MDB's governance. In a 2009 interview, President Enrique García stated: "Whatever happens, the developed countries will never have more than 10% or 15% of the shares and that makes a lot of difference. Developing countries know we are loyal partners" (O'Shaughnessy, 2009). Both the IADB and the African Development Bank were founded with the similar intention of being controlled by borrowers, but ended up giving non-borrowing shareholders greater voting power to gain highly-rated callable capital and improve their standing in international capital markets (see Chapter 2 for IADB and Strand, 2001 or Mingst, 1990 for the African Development Bank). The CAF has evidently made the decision to forgo the "easy" route to better capital market access through callable capital, and instead maintain borrowing shareholder control and build up market access through its track record and strong financial ratios. A top CAF treasury official addressed the issue candidly in an interview: "From countries that are not investment grade, ratings agencies won't consider callable capital in the same way. But callable capital is not something that we are focused on anymore" (CAF interview, December 14, 2010).

The contrasting composition of shareholders, then, is clearly a major factor in defining how cheaply the three MDBs can borrow on international capital markets. As one former top World Bank finance official wrote, with perhaps some exaggeration, "…ratings agencies do not actually base their rating of the MDBs on the spurious sophisticated and often confusing, if not almost irrelevant, financial ratio analysis they purport to impress their readership with. Instead, they now appear to be basing their judgment solely on the strength of usable callable capital" (Mistry, 1995, p. 73). A former MDB analyst from one of the top three ratings agencies attributed this tendency in part to the fact that many people in the agencies did not have a strong background in finance, but rather came international affairs, and hence focus on sovereign ratings and callable capital as an easy yardstick when analyzing MDBs (Ratings agency interview, August 20, 2012).

In large part because of the high share of callable capital guaranteed by non-borrowing, highly-rated industrialized countries, both the World Bank and IADB are rated AAA, and consequently issue bonds at some of the lowest rates of any issuer in the world, sovereign or non-sovereign. The CAF, by contrast, could not get rated at all for the first two decades of its existence, and even now borrows at rates considerably above the other two (though, critically, below any of its member countries). This difference in capital market access, in turn, is fundamental in defining the rates at which each MDB is able to offer loans to its borrowers. Hence, there appears to be little difference as far as the markets are concerned between the World Bank and the IADB—both receive a AAA rating, despite the fact that non-borrowing countries have less voting power in the latter.

Largely driven by the differences in market perception of shareholders and the security of callable capital, the World Bank and IADB can borrow money from international capital markets at relatively similar and very low rates, while the CAF must pay a considerable premium. Constructing a comparative time series of the total funding costs for each MDB (including all currencies and maturities of the many bonds each issues every year) is not realistic, but a recent example demonstrates the overall pattern. In 2011 all three MDBs issued five-year, US$ bonds, at the following yields: World Bank (IBRD) 1%, IADB 1.375%, CAF 3.625% (Bloomberg L.P., 2012). Top-level finance officials in all three banks confirmed that this pattern has held true over the last two decades.

4.3 Net Income, Reserves and Equity

Beyond the price an MDB must pay to borrow from international markets, policies around net income, reserves and equity also have a major impact on the financial terms of loans. The net income generated by each MDB each year—that is, total income (from loans and other investments) minus total expenses (financial and administrative)—has in most years amounted to a tidy sum of money for each of the three MDBs considered here. From 1980 to 2009, annual net income (in 2007 US$ terms) averaged US$1.8 billion annually and totaled US$53.4 billion for the IBRD; US$646 million annually and totaled US$17.8 billion for the IADB; and US$155 million annually and totaled US$3.3 billion for the CAF.

The first question to be asked when considering annual net income is, why does it exist at all? If an MDB is a non-profit organization, does not the existence of net income imply that it is charging too much for its loans? As a cooperative bank owned by all its members, shouldn't it lower the cost of its loans to the point where it simply breaks even? The fact that MDBs do have net income, and that country representatives as opposed to management decide how to use it, indicates that political considerations are involved. Each of the three MDBs analyzed here set their loan rates in such a way to generate a certain level of net income every year, which is in turn used for three purposes: (i) to increase financial security; ii) to expand equity and hence operational capacity; and iii) to fund any other projects shareholders may deem suitable. These three incentives to increase net income translate directly into higher loan costs to borrowing countries.

4.3.1 Uses of Net Income I: Building Reserves to Protect Non-Borrowing Shareholders

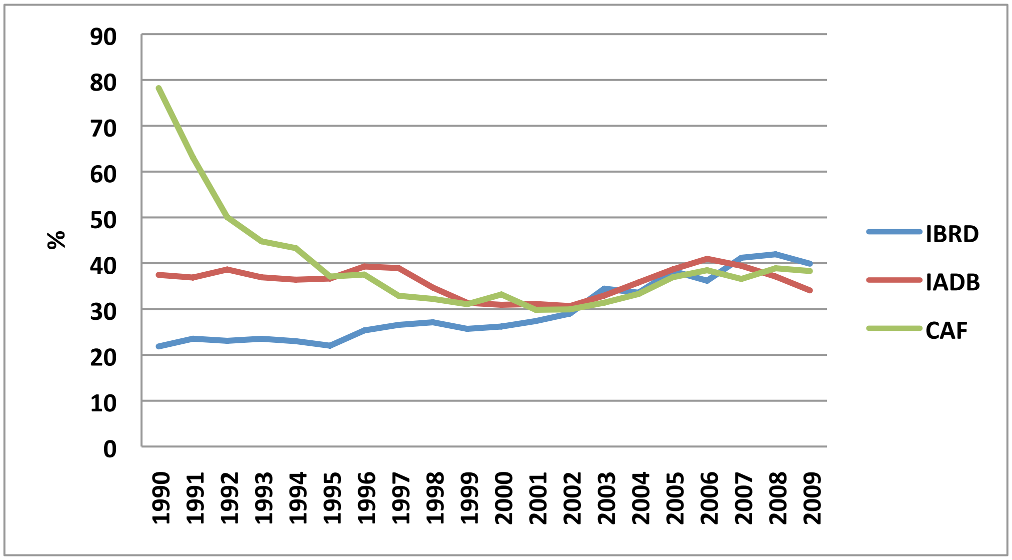
One of the principal reasons for generating net income every year is to strengthen an MDB's financial reserves in relation to its loan portfolio, which—as the name implies—provide an added level of security, as in any financial institution exposed to potential risks. Both the World Bank and IADB have systematically built up reserves since their inception, making allocations out of net income every year to reach a total of just under US$30 billion for the World Bank and US$15 billion for the IADB by 2009. The CAF, by contrast, did not begin building reserves in its early years, and began in earnest only in the late 1980s as it began to seek capital from international markets (see Chapter 2). The CAF's reserves were just under US$2 billion at end-2009.

This pattern of reserve accumulation is justified by MDBs as necessary to reassure bond investors that their investment is well protected, even in the event of defaults by borrowers, as well as to cover any unexpected operational expenses. A quote from a 2006 IADB report sets out the basic premise: "The net income target was intended to set a level of net income that would permit the Bank (i) to cover current expenses in the context of changing financial markets, and (ii) to accumulate reserves as a way to protect debtholders and equityholders of the Bank of potential unexpected losses" (2006a, p. 18). However, the pattern of reserve accumulation suggests that protecting bondholders and access to financial markets is not the only consideration in mind, especially for the World Bank and IADB.

The key to understanding MDBs' policy of systematically allocating net income to reserves—at the expense of borrowing countries, who pay the cost for this in higher loan interest rates—is the equity-to-loans (E/L) ratio. This ratio is the principal benchmark by which financial markets consider the capital adequacy of MDBs (and indeed of all banking institutions). The level of an MDB's equity capital is the main indicator by which MDBs themselves measure their own financial health. Equity here refers to an MDB's i) paid-in capital and ii) level of reserves, otherwise known as retained earnings. In essence, each MDB's level of equity defines the amount of lending it is able to make.

The World Bank publicly targets an E/L ratio of 23-27% (World Bank, 2010d), while the IADB targets an even higher 32-38% (IADB, 2006a). The CAF has no publicly stated official E/L target. In practice, the ratios of all three MDBs have converged to a similar level in recent years, in the 30-40% range (Figure 4.3).

Figure 4.3. Equity to Loans, 1990-2009



Source: World Bank AR, IADB AR and CAF AR, 1990-2009.

On the face of it, the level of this relatively technical financial ratio may seem unremarkable. It takes on a new relevance, however, when one realizes that it is very far above the capital adequacy levels of commercial banks. The Swiss banking giant UBS, for example, had a Tier 1 capital ratio[41] of 11-16.7% between the end of 2008 and the third quarter of 2010 (UBS, 2010), while Citigroup had a Tier 1 capital ratio of 12.5% in the third quarter of 2010, down slightly from 12.7% from the previous year (Citigroup, 2010). These post-crisis ratios, it should be noted, are well above the single-digit ratios held prior to 2008.

Thus the question arises: why do MDBs have capitalization ratios so much higher than commercial banks? Why not, instead, lower the capitalization ratio to a level more akin to

[41] Tier 1 capital, as defined by Basel I and II, is equivalent to equity plus retained earnings as a share of risk-weighted assets. For political reasons, MDBs do not (at least publicly) risk-weight their loan portfolios.

commercial banks? This would have the benefit of requiring less capital contributions from shareholders, less annual allocations to reserves (and hence lower loan costs) or allow greater lending capacity, or some combination of all three. One might imagine that the answer would be the attitudes of bond markets, due to the political nature of MDB business, but evidence suggests that this is not the case. Referring to the very high E/L level, one World Bank Treasury official stated flatly that the World Bank could double its lending and still maintain the AAA rating (World Bank interview, January 20, 2009). A second Treasury official agreed, adding that the E/L ratio is "way above what the market looks for" (World Bank interview, November 17, 2009). An IADB Treasury official suggested that ratings agencies pay more attention to MDBs staying roughly in line with one another, and not any particular level of reserves or equity. "Let's say we lower our equity-to-loan ratio from 30 to 15%. They [rating agencies] will look at how it compares to other MDBs—if it's totally out of whack they will get worried, but if it's in line with the others, and there's a good justification, it will be fine. They look at what our competitors do" (IADB interview, November 15, 2010). A World Bank alternate executive director for one middle-income Latin American country stated in an interview that the E/L ratio "is defined by the board, and there is no technical or mathematic reason why it is set at this level. Our feeling is that the bank is too conservative, but this decision was made years ago and no longer comes up for discussion, because the ratings agencies are used to it" (World Bank AED interview, December 14, 2011).

The ratings agencies themselves do seem to place a considerable amount of emphasis on the E/L ratio, as judged from the financial reports. In on-the-record interviews done with all three agencies done for this research, the analysts all maintained that if the ratings dropped significantly, it could impact ratings. When pressed why the MDBs should have E/L ratios so much higher than private banks, a Moody's analyst acknowledged that the ratio could drop without an impact on the rating (Moody's interview, August 13, 2012). A former analyst with 10 years' experience rating MDBs at one of the top three agencies, who requested anonymity to speak more freely, agreed with the MDB treasury staffers quoted above. "Viewed strictly as a financial institution they could come down quite considerably. Certainly 20% would not be a problem, and something below that would be doable as well" (Ratings agency interview, August 20, 2012).

The high E/L ratio is all the more puzzling when one considers that both the World Bank and the IADB (though not the CAF) have a huge amount of callable, guaranteed capital that is not included in equity, but which shareholders are obligated by international treaty to provide in case of need. This vast on-call reserve—totaling US$172 billion for the World Bank and US$97 billion for the IADB, both in 2009—is unique to MDBs, and does not exist for commercial banks. Taking into account the additional security of callable capital, the E/L ratio of the World Bank and IADB is even more conservative. Evidence suggests that the callable capital itself, and the fervent desire of wealthy shareholders to avoid any call on it, is a driving force behind MDBs building up equity through net income allocations far beyond the requirements of the market.

Moody's notes this in its analysis of the World Bank: "The IBRD realizes that by having enough resources of its own to absorb risk, it protects members from a possible capital call. The Bank judges its capital adequacy as the ability of its equity to generate future net income to support normal loan growth and respond to a potential crisis without having to resort to a call on capital" (2008, p. 4). This use of reserves is substantiated by an interview with a top official in the World Bank's Corporate Finance division, which sets financial strategy. When asked why the World Bank maintained such high E/L ratio, the official agreed that it was well beyond what bond markets called for, and went on to explain why: "The rating agencies know that callable capital is there to bail bondholders out. But shareholders traditionally have not wanted us to call capital. A call on capital is something they want to avoid, because it's not something in their budget, it would come out of nowhere. So the history of the Bank has always been to manage its finances to avoid a call on capital" (World Bank Corporate Finance interview, January 20, 2011).

The motivation is similar with the IADB, as noted in a Moody's analysis (2010, p. 10). An IADB Treasury official confirmed this explanation, justifying high reserves by comparing the IADB to how a commercial bank could face a crisis: "An MDB cannot fire a bunch of people, we can't divest or sell our assets, there's no one to sell our loans to. So we have to rely on the retained earnings...Ultimate we are trying to protect—in our case it's not bankruptcy, its callable capital. The main non-borrowing shareholders, especially the US, do not want to get called on" (IADB interview, November 15, 2010).

The reality for both the World Bank and IADB is that while callable capital is extremely useful for ensuring the best possible rates on international capital markets, it cannot ever be actually used without facing dire political consequences. Wealthy governments are happy to commit callable capital, as long as they never feel that it will actually be called upon. Thus it is incumbent upon the administration of both MDBs to protect against a capital call by building up a very high level of equity as a share of loans, far higher than any commercial bank. It is no coincidence that no MDB has ever made a call on its callable capital—the result would likely be the demise of the MDB itself. As one World Bank executive director put it succinctly almost four decades ago, "Management and the Board should think about callable capital as a Christian thinks about heaven, that it is a nice idea but no one wants to go there because the price of admission is death" (Canadian ED Claude Isbister on April 27, 1973, quoted in Kapur et al., 1997, p. 991). The result of this extremely cautious financial management in the service of protecting non-borrower callable capital is higher interest rate charges on loans to borrowers.

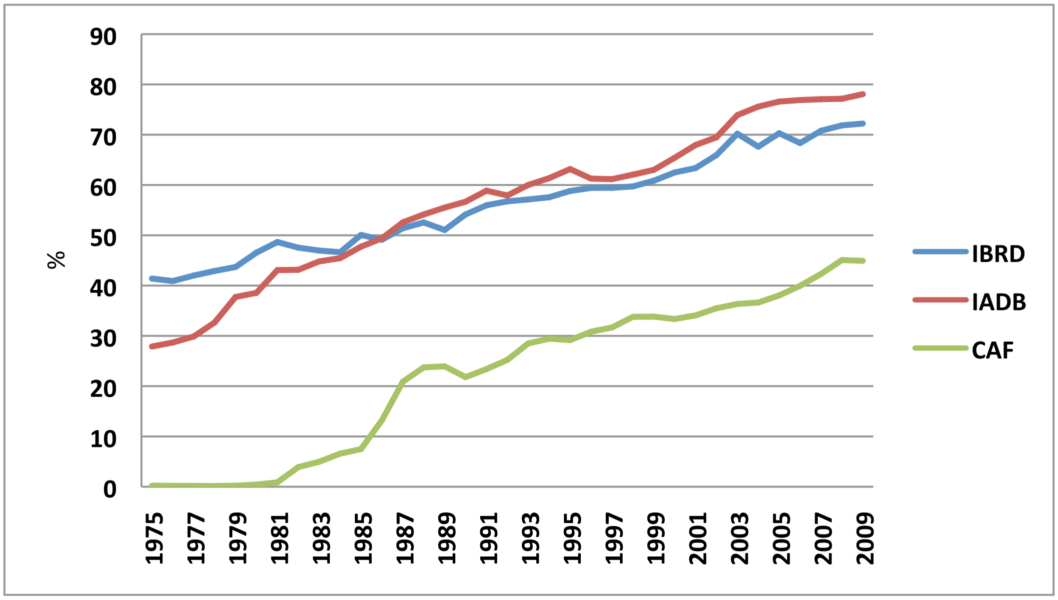
Interestingly, the CAF apparently feels pressure to follow a similar policy, even though it has only minimal callable capital. One can imagine that, as the IADB official quoted above alluded to, ratings agencies may not have a fixed number in mind when analyzing different MDBs, but they expect them to follow a relatively similar pattern. One can also imagine that the World Bank, with its long history and weight in the market, sets the standard, forcing others like the CAF to follow its lead to ensure good bond ratings, even though it does not have a direct financial reason to do so. Hence, the reason for MDBs to charge higher loan rates and accumulate net income is evidently divergent shareholder interest (industrialized countries protecting against a call on capital vs. borrowing countries wanting cheaper loans), but the effects appear the same regardless of the balance of shareholder power in each MDB, due to embedded market expectations.

4.3.2 Uses of Net Income II: Building Equity With Reserves Instead of Paid-In Capital

Once one assumes that MDBs are targeting a given E/L level, the question is then how one achieves it. As noted above, equity is comprised of both reserves (which is accumulated net income) and paid-in capital from shareholders. If an MDB needs to achieve a certain equity target to be able to make a certain amount of loans, why not do so by increasing paid-in capital, instead of generating reserves out of annual net income, which in turn come from the fiscal accounts of the very countries the MDB is supposed to be helping through higher interest payments on MDB loans? Evidence suggests that building equity through reserve accumulation is simply a lot easier than convincing wealthy shareholders to kick in more paid-in capital through contentious and protracted capital increase negotiations. This is much more of an issue for the World Bank and IADB than the CAF, as can be seen in Figure 4.4—although all three have converged since the mid-1990s toward a roughly similar overall E/L ratio, the World Bank and IADB have relied much more heavily on reserve accumulation to do so, while the CAF has done so more by increasing paid-in capital.

The reasons for these divergent patterns of building equity are directly linked to the composition of shareholders behind each MDB. For both the World Bank and IADB, capital increases—especially of paid-in as opposed to callable capital—are extraordinary complex, conflictive and time-consuming endeavors, and hence both MDBs find it much more expedient to gradually build equity each year by allocating much higher levels of net income to reserves. While both the World Bank and IADB were given capital increases in response to the recent global financial crisis, the process was extremely lengthy and the amount of paid-in capital was at the lower end (for the World Bank) or well below (for the IADB) the amount originally proposed by the MDB itself.

Figure 4.4. Reserves as a Share of Equity, 1975-2009



Source: World Bank AR, IADB AR and CAF AR, 1975-2009.

The IADB first announced it was seeking a capital increase on February 25, 2009 (BNAmericas, 2009), and it was not finally approved until July 21, 2010 (IADB, 2011d). IADB management itself did not publicly name a figure for the capital increase, but an independent commission created by the IADB proposed US$150 billion, of which US$6 billion would be paid-in capital (IADB, 2009). Shareholders approved only a US$70 billion increase, of which only US$1.7 billion was paid-in capital. News reports indicated that the U.S. was the main country trying to limit the size of the increase, while borrowing countries such as Argentina were pushing for a higher amount (Thompson, 2010).

The World Bank formally proposed a capital increase in the Istanbul Annual Meetings in September 2009, and it was agreed by April 2010 (World Bank, 2010c). The World Bank's Development Committee originally proposed a paid-in capital increase of US$5-11 billion (World Bank, 2009b), and shareholders agreed to only US$5.1 billion paid-in capital increase, out of a total of US$86.2 billion. Press reports indicate that attitudes about the capital increase were clearly split along non-borrower versus borrower shareholder lines, including outright initial opposition by France, Canada, Italy, and the

United Kingdom and lukewarm support by the US, with support from major borrowing countries such as Brazil, China and Indonesia (see for example Reuters, 2009 and Bloomberg, 2009).

A top World Bank Treasury official linked loan prices, net income and politics bluntly: "In order to ask for a lower capital increase, we can increase amount of money we earn on loans…This generates greater net income, which is allocated to reserves and hence can be used for lending…We try to minimize capital increases as much as possible, because of the political difficulties involved" (World Bank interview, November 17, 2009). A World Bank strategy paper also alluded to the link between loan pricing and capital, when discussing a loan price increase in 2009: "While the objective of this pricing increase was to improve the institution's financial sustainability, it would also gradually enhance IBRD's capital position as higher income is added to reserves over time" (2009c, p. 3).

Borrowing country shareholders have objected to this practice, voicing instead a clear preference for a direct capital increase. As far back as 1995, Argentina's Finance Minister Domingo Cavallo stated at the Annual Meetings that while his country "supported the policy of sound reserves…If the net income of the Bank were to continue at the levels of recent years, we feel that interest rate waivers could be increased in order to reduce the actual cost of borrowing to our countries" (World Bank, 1995, p. 135-6). Brazil's current executive director at the World Bank pointed out in an interview that price increases in place of a capital increase could make the Bank's loans unattractive to his and other countries. "This would be a disaster for the financial cooperative, because the lower middle-income countries would take the burden, and lending costs would have to increase much more significantly than now. That would be unsustainable. So you have to ask whether increasing prices is the best way to address financial sustainability. A direct capital increase would be much better" (World Bank ED interview, December 12, 2011). Another current alternate executive director from Latin America raised similar objections, saying that borrowers are unable to influence capital increases and that G7 countries prefer to increase loan prices as a way to avoid capital contributions (World Bank AED interview, December 14, 2011).

The IADB faces a similar dynamic, except that it receives much stronger pressure from its single largest shareholder, the United States. An independent commission convened in 2009 to consider the possibility of a capital increase for the IADB put the issue succinctly: “The Commission fully realizes that there is bound to be resistance to the notion of a general capital increase, albeit one that consists largely of guarantees and of limited actual cash transfers. The United States, at 30% the single largest shareholder of the Bank, is at present facing many demands on its budgetary resources, both for guarantees and for actual cash transfers” (IADB, 2009, p. 4). As a result, the IADB “relies on a small amount of paid-in capital, averaging 4 per cent in the last 30 years, augmented by retained earnings” (Ibid., p. 5) An IADB Treasury official confirmed the importance of generating retained earnings to avoid requesting capital from major shareholders. “If overall we want to increase lending, we have to increase loan charges to generate retained earnings.” The official went on to note that the reason was the split between borrowing and non-borrowing shareholders, with the latter resisting capital increases that serve to provide subsidized loans to the former. “We know the IBRD is getting similar pressure from its non-borrowing shareholders, but in our case the U.S. is 30%, so it carries a big stick, it has a huge voice” (IADB interview, November 15, 2010).

The contrast with the CAF is stark. As the figure above shows, a much lower portion of the CAF’s equity comes from retained earnings, and much more from paid-in capital. The reason is simply that shareholders are much more willing to contribute paid-in capital when the organization needs it, thus the CAF is less reliant on building up reserves to achieve a given overall E/L ratio. The recent global financial crisis is a good example. Facing potential financial constraints to service increasing loan demand from member countries, shareholders quickly and unanimously approved a US$2.5 billion paid-in capital increase in August 2009 (CAF AR, 2009). A CAF Treasury official detailed the ease of the increase in an interview, with no small note of smugness in his voice: “We asked shareholders for US$1 billion, and instead they gave us US$2.5 billion. We can increase the capital base whenever we need to, because the structure of our shareholders is so different. They know we can leverage the capital that they supply as efficiently as possible, which then gives them greater possibilities to take out loans from us. It's not like that with the IADB and the World Bank, where some shareholders contribute capital and others benefit by taking out loans" (CAF interview, December 14, 2010). Including paid-in capital from new members, the CAF raised US$4 billion in paid-in capital following the 2008 crisis, almost as much as the vastly larger World Bank (US$5.1 billion) and more than twice as much as the IADB (US$1.7 billion) (CAF, 2009b). A ratings agency analyst contrasted the CAF's capital increase with the IADB's in an interview: "If you see how much trouble IADB has had in getting significant capital injection, it's been like a Mexican soap opera it's taken so long, compared to how quickly the CAF got it done" (FitchRatings interview, November 22, 2010).

As this section makes evident, the structure of shareholding countries has a very important impact on each MDB's ability to raise paid-in capital, which in turn directly influences whether it has an incentive to raise loan charges as a means of building equity without having to face politically difficult capital increases. The fact that a major share of paid-in capital for both the World Bank and IADB must come from country shareholders that do not borrow from these MDBs means that paid-in capital is much harder to come by. As a result, both the World Bank and IADB have a stronger incentive to generate a relatively high amount of net income every year to build equity without recourse to a capital increase. Accumulating reserves through higher loan charges is an extremely effective way for the World Bank and IADB to expand lending capacity without turning to shareholders for a capital increase. These reserves act, in essence, as a paid-in capital contribution from borrowing members alone, but without any increase in their share of voting power that normally could come with a formal capital increase. As one Latin American alternate executive director put it, using net income in this way could be understood as a capital increase, which should—but does not—give borrowers more voting power (World Bank AED interview, December 14, 2011). The dynamic within the CAF is quite different. Shareholders see the CAF as a useful tool to serve their own interests, rather than donor aid with dubious effectiveness, and hence increases of paid-in capital are much more easily available. As a result, the pressure to use loan charges and net income as means of building equity is much lower.

4.3.3 Uses of Net Income III: Allocation to Fund Shareholder Programs

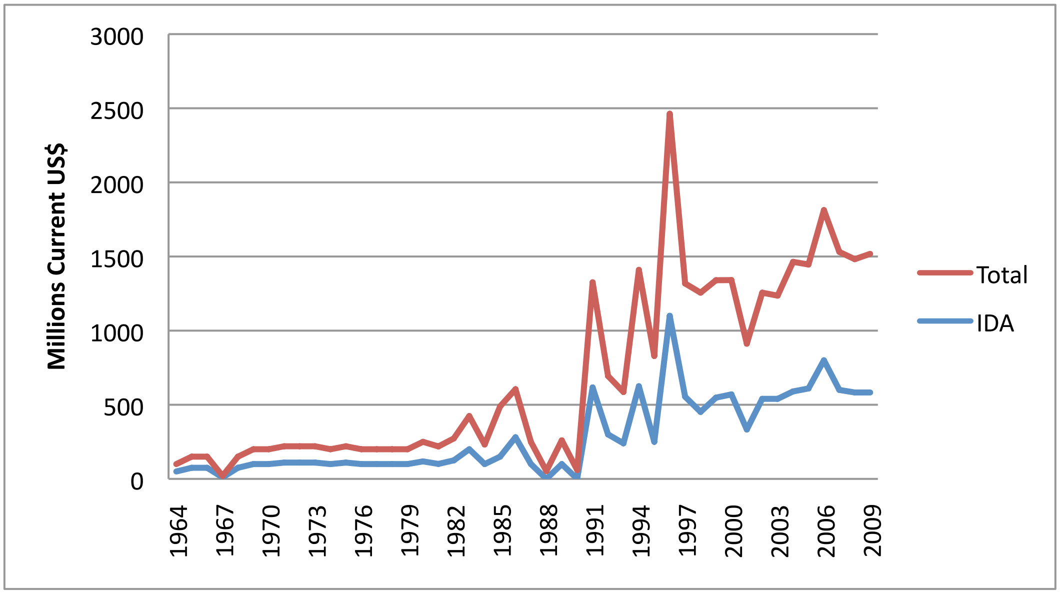
A third important reason for an MDB to generate net income each year is that shareholders can allocate that income not only to reserves, but also to special purposes that most often obey the interests of the wealthiest and most powerful non-borrowing shareholders, rather than borrowing country shareholders. This is a major and conflictive issue for the World Bank, and has grown in financial importance in recent years. The issue has a smaller but growing importance for the IADB, and is essentially non-existent for the CAF—thus clearly matching the balance of shareholding power between borrowers and non-borrowers in the three MDBs.

The issue of allocating net income for purposes beyond building reserves first arose at the World Bank when IDA was created, in the early 1960s. The Bank had begun accumulating very considerable retained earnings, and was at the time facing pressure from borrowing countries to lower the costs of its loans rather than continue building reserves. At the same time, the Bank faced pressure from many countries—backed by the United Nations and, eventually, the U.S. government—to offer loans at much lower rates to the poorest countries. The creation of IDA allowed the Bank to address both of these issues. It ensured that the new concessional lending window would be housed within the World Bank rather than the United Nations (with the support of the U.S., which exercised much greater voting power in the Bank and could hence better control the resources), and it offered an opportunity to dedicate some of its net income every year beginning in 1960 in such a way that it stayed "in house" and under the Bank's control (see Chapter 2).

Thus began the annual practice of allocating part of the World Bank's IBRD net income to IDA, which continues to this day. While this might seem reasonable at first, it is important to recognize that this income comes directly from the interest payments made by World Bank borrowers. These borrowers frequently suggest that IDA should be funded not by them, but rather by fiscal allocations from the wealthiest countries. Why, after all, should slightly better-off developing countries be made to pay for loans to the poorest countries? In the words of one researcher, this “could be seen as a transfer from one set of developing countries to another” (Mohammed, 2004, p. 12). Predictably, the annual debates on IDA allocations are invariably split by borrower versus non-borrower shareholders, and just as predictably, non-borrowing shareholders always win. The debate began in the early years of IDA, with especially vocal opposition to transfers from Brazil and other Latin American countries (Kapur et al., 1997), and continues to this day. One World Bank Treasury official, who has the job of marketing loans to middle-income countries (MICs), said “MICs who pay for IBRD loans say ‘Wait a minute, now we finance IDA? IBRD wasn’t created for that.’ This certainly hurts our ability to be competitive in terms of pricing” (World Bank interview, September 15, 2010).

What’s more, this allocation appears to have become increasingly institutionalized, as a convenient way for wealthy shareholders to use the World Bank’s IBRD net income to minimize the amount of money they are requested to contribute to the regular IDA replenishments. In previous years, shareholders understood that the World Bank would give IDA part of IBRD net income as conditions permitted, and the Bank was very clear that this was not an obligation—even going so far to write language to that effect in IBRD bonds, to reassure capital markets of its independence from IDA (World Bank AR, 1960). More recently, however, IDA replenishments (as well as contributions to HIPC and MDRI debt relief initiatives to IDA countries) have included prior commitments from IBRD of certain amounts of net income allocation. This in effect *requires* IBRD to generate sufficient income through loan charges to meet the commitments (see for example World Bank, 2009c). “In the past IDA transfers were sometimes scaled back or stopped if the capital outlook wasn’t good,” said a World Bank Corporate Finance official. “That’s less so the case these days, for sure” (World Bank interview, January 20, 2011). A World Bank Treasury official stated flatly, “Profit allocation for IDA seems to be one of the main goals of the board every year” (World Bank interview, September 15, 2010).

Figure 4.5. IBRD Net Income Allocations, 1964-2009



Source: World Bank AR, 1964-2009.

Cumulatively, transfers to IDA and debt relief add up to a very considerable sum of money: US$13.3 billion since 1960 in nominal terms and US$24 billion in real terms (Figure 4.6). To all intents and purposes, the World Bank's non-borrowing shareholders are forcing middle-income developing country borrowers to contribute to less developed countries. Needless to say, this is not a contribution that borrowing countries generally feel they should have to make. "It's definitely a negotiation every year, what are prices going to be and what transfers are going to be," a top World Bank Corporate Finance official said. "There's a trade-off. Certainly the higher loan prices are, the more can be afforded to transfer out to IDA. And the lower IDA transfers are, the lower loan prices could be…That's certainly something that's very different between us and IADB and CAF" (World Bank interview, January 20, 2011).

Interviews with shareholder representatives at the World Bank make it clear that borrower countries strongly object to allocating net income for IDA, and feel that these are forced on them by non-borrowers wanting to minimize their own budget allocations to IDA replenishments. The current Brazilian World Bank executive director as well as a Latin American alternate executive director both complained that not only are they being forced to contribute to IDA through higher loan prices than would otherwise be the case, but that they are not even given credit as having made contributions at all. "They say that 'the Bank' or "the shareholders' contributed to IDA countries…Many MICs are raising the point that the Bank should recognize that transfers to IDA are from MICs, in order to receive an increase in voting share, or at least to compensate" (World Bank AED interview, December 14, 2011). Non-borrower EDs interviewed, including representatives of Switzerland, the U.S. and the U.K., said instead that the allocations were fully justified and came from the Bank's capital base, to which they contributed the largest share (World Bank ED interviews, January 13, 2012; January 25, 2012; January 30, 2012).

Shareholders have also taken to allocating grants out of IBRD net income in most years for purposes that are linked to the geopolitical interests of major non-borrowing shareholders. Since the mid-1980s, grants have been allocated to trust funds for the former Soviet Union, Gaza-West Bank, Bosnia, Kosovo, East Timor, Liberia and Lebanon, as well as emergency assistance for Rwanda and post-tsunami recovery in South Asia. A middle-income IBRD borrower in Latin America may wonder why they are in effect contributing to a trust fund intended to address the Israeli-Palestinian conflict or ethnic tensions in the Balkans—both clearly of major interest to western Europe and the United States. Between 1985 and 2009, grants out of net income have totaled US$1.9 billion, or US$2.4 billion in real terms. Between 2010 and 2019, they are projected to total another US$100 million per year, equaling US$1.2 billion in foregone reserve equity (World Bank, 2009d). This, of course, translates into higher loan costs to borrowers.

The World Bank's original Articles of Agreement permitted net income to only be used for three purposes: building reserves, reducing loan charges or distributing dividends to shareholders (Kapur et al., 1997).[42] Dividends have never been redistributed, while reserves (as described above) have been built up systematically, not to say excessively.

[42] The current Articles of Agreement, last amended in 1989, stipulate only that the Board of Governors decide annually how net income should be allocated (World Bank, 1989 Article V, Section 14). According to the World Bank's former general counsel, "There is no mention of grants in the Bank's articles, however…Grants from the IBRD net income were authorized by a formal interpretation issued by the Executive Directors in July 1964" (Shihata, 2000, p. 85-6).

However, instead of taking the third option of reducing loan charges, non-borrowing shareholders have instead grown accustomed to using net income as a slush fund, allowing them to fund programs that suit their own interests, and not necessarily those of borrowing countries, without requiring actual direct fiscal allocations out of their own budgets. As the Brazilian executive director put it, "Developed countries want to milk it like a cow, to take the place of bilateral contributions" (World Bank ED interview, December 12, 2011). The total amount of these allocations since they began in 1964 and 2009 is US$18 billion, or US$29 billion in real terms—an average of US$630 million per year in real terms. Between 1975 and 2009, the World Bank's IBRD loan income averaged US$7.5 billion in real terms annually, meaning that if annual allocations out of net income had not occurred, the interest and fee payments made by IBRD borrowers on their loans could have been reduced by 8.4%.

By contrast, the IADB makes only very limited allocations out of net income annually. The IADB's concessional lending window, called the Fund for Special Operations (FSO), is funded entirely by contributions from both borrowing and non-borrowing shareholders during the capital replenishment processes (there have been nine thus far in the IADB's history, the most recent in 2010). Part of the reason for this may be that FSO lending volumes are so small (only 6% of total lending between 2000 and 2009, compared to 40% for the World Bank's IDA) that it can finance most of its needs from repayments on old loans and on limited income from investing its existing capital stock, and needs only small levels of replenishments. Hence pressure to allocate out of net income from the regular lending window (Ordinary Capital) is much lower. Only for a period of five years, between 2000 and 2004, did a small portion of OC net income go to FSO, totaling US$136 million (IADB AR, 2000-2004).

Similarly, all debt relief contributions from the IADB (totaling US$4.4 billion through 2010) are financed directly from FSO itself, and not from OC resources (IADB, 2011e). Starting in 2005, the IADB began listing "special programs" under administrative expenses, which were defined in the financial statement as "non-reimbursable and contingent recovery assistance to borrowing member countries" (IADB AR, 2005, p. 116

note B), but again the total value was very low, only US$246 million between 2005 and 2009. The impact of these two sets of allocations on loan pricing is obviously minimal.

The ninth capital replenishment in 2010 called for the IADB to allocate US$200 million annually out of OC net income until 2020 for Haiti reconstruction—the first of this type of regular allocation of this kind. According to several executive directors from both borrowing and non-borrowing countries, this allocation was demanded by the U.S. in return for its support to increase the IADB's capital. Brazil's executive director at the IADB said his country supported helping Haiti, but nonetheless opposed the allocation. "We said to the U.S., 'why us?' Do it by yourself, not with our money, because in the end we take loans and the bank increases the interest rate to transfer this income for Haiti. We argued this with the U.S. government. We have the intention to help Haiti, but we do it directly. But in the end, the request was done" because otherwise the U.S. threatened to block the capital increase (IADB ED interview, January 10, 2012).

Whether this allocation signals future use of IADB's net income in ways similar to the World Bank remains to be seen, but by all accounts non-borrowers will continue to push for it. The UK's representative to the IADB's annual meeting in 2008 stated the rationale clearly in a speech: "We have heard our FSO colleagues calling for a larger FSO window, and we think this is something that the IDB should consider as an option for the use of its net income" (IADB, 2008). A 2010 U.S. Treasury statement of position on reform priorities states that the IADB should "provide net income transfers to fully support concessional window (FSO)" (U.S. Department of Treasury, 2010a). According to the IADB's Argentine executive director, the issue was raised by several non-borrowers during the recent capital increase, and the idea was uniformly opposed by the borrowing country shareholders (IADB ED interview, January 13, 2012).[43]

The CAF first began setting aside portions of annual net income for special purposes in 1995, in relatively small amounts. Annual allocations have grown progressively over

[43] Such a shift would be all the more interesting (and likely conflictive) considering that the U.S. insisted on veto power over all FSO operations when the IADB was created, specifically because of the amount of money the U.S. contributed at the time (see Chapter 2).

time, to reach US$70 million allocated out of net income in 2009 (CAF AR, 1995-2009). However, only a portion of these allocations go to what might be considered "needy" causes—a large portion is dedicated to a technical assistance fund to help countries prepare project proposals, and another sizeable portion is for pre-funding of major infrastructure projects. Both of these funds are better viewed as business development grants intended to result in major CAF loans. A smaller amount goes to the Human Development Fund, which promotes sustainable development projects for the very poor. The exact breakdown of these funds is not available for every year. In 2009, the CAF committed US$8.2 million via the Human Development Fund, a tiny amount compared to the US$8.8 billion in total lending commitments that same year (CAF AR, 2009). Hence, making use of net income for shareholder purposes beyond reserve accumulation, so prevalent in the World Bank and also present in the IADB though to a lesser degree, is almost non-existent at the CAF, due to the lack of non-borrowing shareholder pressure.

4.3.4 Summary of Net Income Issues

The divergent interests of borrowing and non-borrowing shareholders play a major role in shaping the incentives facing each MDB to accumulate and allocate net income each year, which in turn has a direct impact on the cost of loans. Non-borrowing shareholders have a strong motivation to build up net income to: i) maintain capitalization ratios well beyond what a private bank needs, to better protect the callable capital for which they would be disproportionately liable; ii) build equity through reserves rather than increasing paid-in capital out of their own budgets; and iii) use "surplus" net income to fund projects and causes obeying their own interests and not necessarily those of borrowers. Because net income comes mainly from loan charges—which are paid entirely by borrowing countries—non-borrowers have no incentive not to make use of this mechanism.

In the World Bank, non-borrowers have all the voting power necessary to make these allocations each year during the Board of Governors meetings, over any objections from borrowers that net income should be used to reduce loan prices, as provided for in the Bank's Articles of Agreement. In the CAF, by contrast, control by borrowing countries means that reserve ratios are kept much lower, since equity can be built through paid-in capital increases, while allocations to special projects are minimal. However, the CAF is still forced to follow the lead of the World Bank and other MDBs in maintaining higher capitalization ratios than it might otherwise, to placate bond markets that have come to accept the World Bank's financial ratios as "normal" for an MDB. The IADB falls between the World Bank and CAF, following a similar pattern as the World Bank in relation to capitalization and equity, but closer to the CAF in relation to net income allocations for special purposes. Evidence suggests that the greater voting strength of borrowers gives them a stronger voice in keeping net income (and hence loan charges) as low as possible, although the U.S.'s veto power over capital increases did result in an agreement to allocate net income to Haiti as part of the most recent capital increase.

4.4 Conclusion

The intention of this chapter has been to explore whether and how the relative interests of borrowing and non-borrowing shareholders influence the price of loans offered by MDBs to borrowing countries, one of the main factors influencing demand for MDB loans. The evidence indicates that shareholder balance of power does indeed shape many financial considerations that impact the cost of each MDB's loans, in ways that generally conform to the positioning of the World Bank at one end of the spectrum, the CAF at the other, and the IADB in the middle.

The World Bank—with dominant voting power by non-borrowing, wealthy countries—has, on the one hand, better access to international capital markets at lower rates, and on the other hand, incentives to boost net income at the expense of borrowing countries to protect and further the interests of non-borrowing shareholders. Hence, while the World Bank can raise capital at extremely low rates, it does not pass on this low cost of funding to borrowers to the degree that it might otherwise.

The CAF, controlled almost entirely by borrowing countries, is at the other end of the spectrum both regarding capital market access—which is much more tenuous due to the lack of wealthy shareholders—and net income incentives—which are almost non-existent as the CAF resolutely minimizes the cost to borrowers above all other considerations.

This dichotomy with the World Bank holds true in all aspects except for the case of maintaining an extremely high (compared to private banks) equity to loans ratio, which is due to the market-defining example set by the World Bank and followed by other MDBs to meet market expectations for how an MDB should manage its finances. The CAF's strong efforts to hold down loan costs have meant that in times of low global interest rates and narrowing spreads on MDB funding (such as the mid 2000s), the interest rate charged on CAF loans to borrowing countries has come down almost to the level of the World Bank.

The IADB, with a slim voting power majority of borrowing countries but veto power by the U.S. over changes to the capital structure, falls in between the two extremes, although it tends more toward the World Bank than the CAF. The fact that the IADB has a number of wealthy non-borrowing shareholders defines its AAA status and excellent access to low-cost financing, despite the fact that non-borrowers do not hold a majority on the board. Regarding net income allocation, the IADB appears to act more like the World Bank in relation to capitalization ratios and the uses of reserves to build equity as opposed to paid-in capital, while it is more like the CAF in that it allocates very little net income to special shareholder projects, concessional financing or debt relief. This lack of allocations to special purposes helps offset the IADB's slightly higher borrowing cost, thus bringing down the cost of its loans to the same level or even at times below that of the World Bank.

5 NON-FINANCIAL CHARACTERISTICS OF MDB LENDING

This chapter continues examining the causal links that might explain the patterns in lending demand analyzed in Chapter 3. The rationale is that loan financial terms (discussed in Chapter 4) are not the sole reason why a country chooses to borrow or not from an MDB—a variety of other non-financial aspects of MDB loan operations also play a major role. This chapter demonstrates that a number of non-financial characteristics of MDB lending are systematically linked to the balance of power between borrowing and non-borrowing shareholders governing each MDB (Hypothesis 1). The chapter also provides some evidence on how these differences impact loan demand (Hypothesis 2), a topic discussed further in the subsequent case study chapter.

The focus here is on the non-financial "hassle factor" required to process a loan, including overall bureaucratic procedures and time to process a loan as well as two specific sets of procedures for loan approval: environmental/social safeguards and procurement rules. Private sources of sovereign finance also require some degree of procedures, but compared to MDBs they are faster, relate simply to the client's ability to repay and make no stipulations on how the borrower can or should spend the resources. Hence, the bureaucratic loan requirements analyzed here are, for the most part, uniformly negative "hassle factors" from the point of view of borrowers, and thus reduce loan demand, all else being equal. Other non-financial characteristics that could influence demand for lending, such as policy conditionality or technical expertise, are much more nuanced and dependent on the circumstances of individual countries, and as such are explored in more detail in the country case studies in the following chapter.

The chapter addresses each of the three topics in turn—overall loan processing time, environmental and social safeguards and procurement procedures. In each case, the research seeks to first establish whether each of the characteristics fall along a continuum from the point of view of the borrower, with the CAF at one end, the World Bank at the other and the IADB in the middle. Second, the chapter traces causal links between the interests of borrowing and non-borrowing countries in establishing the relative positioning of these characteristics along that continuum. Lastly, the chapter presents preliminary evidence linking the characteristics to the evolution of loan demand from borrowers, a topic that will be considered in more detail in the following chapter. Evidence is based on interviews with executive directors (ED) and alternate executive directors (AED) as well as staffers from all three MDBs, and policy documents from the MDBs themselves.

5.1 Loan Approval Procedures and Processing Times

The time MDBs take to design, review, negotiate and approve loans is a significant burden to borrowing country governments, and one brought up frequently in interviews with borrower executive directors as well as government officials (as discussed in the next chapter). These procedures—especially in-country missions—require a considerable commitment of time by top-level ministerial officials who frequently must attend lengthy meetings to discuss project details with MDB staff. As well, many of the projects in question have potentially important economic impacts. Hence the length of time taken to approve them represents a significant opportunity cost for the country. These procedures and times vary considerably among the three MDBs analyzed here (Table 5.1).

Table 5.1. Loan Approval Procedures and Times

	World Bank	IADB	CAF
Approval Time	12-16 months	7-10 months (2007-2009)	3-6 months; 1.5 if urgent
Improvements	None in last 5 years	Down to 5 months avg. in 2011	None
# of Missions	• Identification • Pre-appraisal • Appraisal • Negotiation	• Identification • Appraisal • Negotiations (often VC)	• Identification/appraisal • Negotiations (often VC)
# of Review Phases	• Concept • Quality Enhance • Decision • Board	• Eligibility (often virtual) • Quality/risk (often virtual) • Operations • Board	• Business Committee • Loan and Invest Committee • Board (for larger loans)
Caveats	Decision meeting can be skipped for low-risk invest loans since 2009 (but rare due to risk-averse staff)	• Missions faster than WB (example: negotiations ½ day vs. 2-3 days) • Shorter project documents and reading time before meetings than WB	• Missions faster than either IADB or WB • Loans below US$20 mln approved by operations VP • Loans below US$75 mln approved by president • Non-resident board meets 3-4 times/year; can approve loans by email

5.1.1 World Bank[44]

Estimates of time required to process a World Bank loan from identification to board approval vary greatly according to the type of loan, with investment loans typically taking longer due to more stringent safeguard and procurement procedures than with budget support (adjustment) lending. A 2007 internal study on the World Bank's cost of doing business faced by borrowers reported an average of 16 months for investment loans (World Bank, 2007a), while a presentation in the Bank's Latin America division stated an average of 11-12 months for all types of loans (adjustment and investment) (World Bank, 2008a). Latin American shareholder representatives at the World Bank all said in interviews that loan procedures are far too lengthy, and imply significant opportunity costs, especially for projects that could have major economic impacts. The borrower shareholders placed the blame squarely on non-borrowing shareholders, as voiced by one

[44] The information in this chapter on World Bank loan requirements relates to all borrower countries, not just Latin America. Although there could conceivably be small differences between countries, all policies and processing requirements are the same for every borrower country.

Latin American AED: "With less than 30% of the vote, we are in a weak position to influence in policy design and define performance standards. The shareholding is crucial to define the design of these policies" (World Bank AED interview, December 14, 2011).

Despite repeated discussion of the problem among management and on the Board since 2000, there had not been significant progress speeding up the process. Efforts to streamline internal loan approval procedures, including the 2009 reform of investment lending for low-risk projects (World Bank, 2009a), have made almost no impact on approval speed. Asked why, one operations staffer who has worked both on project lending and in efforts to streamline loan processing procedures said, "The incentives really aren't there. Senior management doesn't want to order people to simplify because they'll get caught in a trap and there'll be some scandal…What happens is that each separate component is fine and make sense, but when you add it up it leads to major delays" (World Bank interview, October 4, 2011).

Most investment loans involve four separate country missions (identification, pre-appraisal, appraisal and negotiations) as well as four full formal internal reviews (concept, quality enhancement, decision to appraise and Board approval) (World Bank, 2012c). Low-risk, repeater investment loans are sometimes allowed to skip the decision meeting as part of the recent investment loan reform, but few loans actually qualify for this procedure due to risk-averse management, according to long-time Operations Policy staffer in the Latin America division (World Bank interview, September 7, 2011). Adjustment lending (providing general budget support) follows a very similar schedule, but with a higher-level decision to appraise meeting. Considering the need to organize the project staff team (all of whom are working simultaneously on multiple projects in different countries), coordinate schedules with government officials, circulate documents for review informally and then again formally 2-4 weeks before all review meetings, and find a slot in the Board agenda, the lengthy approval process should come as no surprise.

Most if not all of the obstacles slowing down the review process were instigated at the behest of non-borrowing countries, against the wishes of borrowers, according to multiple interview sources. An Operations Policy staffer in the Latin America region, who previously worked as a staffer on the Executive Board, said, "The World Bank is majority-owned by Part 1 countries like the US, Japan, France, Netherlands, and the Nordics. So every time there's a screw up, another rule gets written and process gets added, formal or informal. Unfortunately that's the way the place works...These ideas come from the Part 1 countries, they're certainly not the borrowers' ideas—they didn't come to the Board asking for tighter restrictions on how we do things" (Ibid.).

This formalistic, risk-averse and lengthy set of procedures for loan approval also pertains to any modification to a loan that has already been approved. According to an Operations Memorandum on Project Restructuring, staff must prepare a Restructuring Paper to be approved by the relevant country director and signed off on by the regional vice-president (World Bank, 2012d). This process, the operations staffer noted, is required even for something as simple as extending the closing date of a loan—a common problem, particularly with investment projects that run into frequent delays in developing countries for a myriad of reasons (World Bank interview, September 7, 2011). Any restructuring involving safeguard re-categorization or changes to a project's development objectives must be submitted to the Board for approval.

5.1.2 IADB

The overall bureaucratic hassle factor and slow processing times required for loans at the IADB is by all accounts similar to that of the World Bank, but somewhat faster and less onerous to borrowers. According to recent internal data, the average time required for full project preparation and approval averaged 10 months during 2007-2010 for all loans (IADB, 2011f)—slightly faster than the World Bank. Further, the trend was clearly downward, with an average of eight months recorded in 2009 and roughly 7.5 months in 2010 (Ibid.). While the steps to loan approval are similar, the process is more streamlined at the IADB because the borrowing country shareholders had more influence to approve slightly less onerous review requirements, according to a top-level operations staffer who previously worked in operations at the World Bank. Although major non-borrowers would prefer stricter oversight processes, the staffer said that they—especially the U.S.—

limit using their power to issues of major concern, in the interests of more consensual governance in light of the nearly 50-50 split on the board (IADB interview, January 24, 2012).

The number and type of formal steps for sovereign loan approval seem comparable on paper to the World Bank.[45] However, all required documents are considerably shorter than in the World Bank, the reading period prior to review meetings is shorter, and two of the review meetings are "virtual" rather than physical, all of which speed the process up. As well, most projects require only two formal missions, compared to four for the World Bank—a considerable savings of time, especially in light of the need to coordinate schedules among mission staff and government officials. Final loan negotiations usually take place via video conference rather than an in-country mission as with the World Bank (IADB interview, January 24, 2012). While the IADB's procedures were always somewhat less cumbersome than the World Bank's, they have improved in recent years, with more delegation to the team leader with the specific aim of shortening project time to approval, according to a high-level policy staffer (IADB interview, December 7, 2011).

Both staffers and shareholders agreed that the still-lengthy approval times at the IADB act as a disincentive for borrowing countries to take out loans when they have other options, and also that the bureaucratic obstacles overwhelmingly derive from the interests of non-borrowing shareholders. The Brazilian ED stated that, "It's difficult to reduce the speed, because the internal process and all the different committees. This comes from the non-borrowers—we just experienced this in the capital increase, they created a lot of steps in the process, new departments to take care of one issue, and this means the project takes a year instead of six months" (IADB ED interview, January 10, 2012). The Chilean ED painted a similar picture. "Everybody agrees that it's too conservative, but the bulk of the non-borrowers are on the same page" (IADB ED interview, January 24, 2012).[46]

[45] The IADB 2012 lists the major steps as: Develop Project Profile, Eligibility Review, Proposal for Operation Development, Quality and Risk Review, Operations Policy Committee Review, and finally approval by Executive Board (IADB, 2012a).
[46] The Chilean ED specified that he was expressing his own views, not those of his country.

Non-borrowers agreed that they were the cause of much bureaucratic overhead. A European G7 AED said, “We have really strengthened the internal oversight mechanism and environmental and social safeguards and this might perceived by borrowing members as making doing business more complicated with the IADB” (IADB AED interview, January 13, 2012). A second non-borrowing G7 European AED stated that the extra procedures were the result of non-borrowers using their financial leverage to influence policies. “The borrowers consider things like environmental and social safeguards, audits, the Office of Institutional Integrity, the Office of Independent Evaluation, the Independent Complaints Mechanism as overhead, as additional cost to doing business…The non-borrowers consider those to be essential parts of an organization that produces good programs that have a positive economic and development impact on the region. The borrowers say, ‘you aren’t paying for this when you take out a loan,’ and we say, ‘you are not raising the money on your capital, we are’” (IADB AED, January 31, 2012).

Staff and EDs attributed the faster speed of the IADB compared to the World Bank to greater flexibility and less need to rigidly follow the letter of the rule. In large measure this more flexible attitude is derived from the fact that the great majority of the staff are from the region themselves, and many of them are former (and future) government officials. Of the IADB’s nearly 2,000 employees, 68% were from regional borrowing countries at the end of 2009 (IADB, 2012b). A management-level IADB policy staffer said that this familiarity with the region was a strong comparative advantage over the World Bank, and facilitated smoother loan processing (IADB interview, January 18, 2012). The Chilean ED noted that “there is more cultural proximity with the IADB, it’s perceived as more of our bank than the World Bank. I mean, the World Bank’s regional vice-president [U.S. national Pamela Cox at the time of the interview] doesn’t even speak Spanish” (IADB ED interview, January 24, 2012). A Latin American AED at the World Bank who previously worked as a government official dealing with both MDBs put it succinctly: “The IADB works more like Latin America—a lot is based on relationships, not rules. There decision-makers can take decisions; here they are more focused on following procedure" (World Bank AED interview, January 25, 2012).

Shareholders and staff also emphasize the importance of borrowers having more of a stake and a say in the IADB compared to the World Bank. "With the IADB, we feel more comfortable borrowing, because more than half the shareholders are countries that also borrow. With this, psychologically many countries prefer the IADB to the World Bank," said the ED staff from a middle-income borrower country (IADB ED staff interview, January 24, 2012). Two G7 European AEDs agreed, one saying, "There's probably more trust in us than in the World Bank. They see this as ultimately a bank that they have 50.01% control over" (IADB AED interview, January 31, 2012). A management-level staffer echoed these comments: "I think the IADB is perceived more as a bank owned by the borrowers. This is more their bank than the World Bank. This issue of belonging, having more influence on the institution, makes some countries prefer the IADB" (IADB interview, January 18, 2012).

5.1.3 CAF

The CAF's loan approval procedure is far faster and less formal than either the other two MDBs. Major loans routinely move from conception to final approval within three months, or even faster if the country needs it, according to several CAF operations and policy staffers interviewed. All concurred that the reason for the reduced bureaucracy is directly linked to the fact that borrowing country shareholders control the institution, unlike the World Bank and IADB. "We have definite advantages in terms of flexibility and reaction time compared to the other multilaterals," said one operations staffer. "This is from our operating design and type of administration. We are much less rigid than the other multilaterals, which have certain impositions from donating countries that we do not" (CAF interview, May 25, 2009).

Rather than facing five or six levels of review for each loan prior to reaching the executive board, as with the other two MDBs, CAF loans face only two review levels, according to staffers in operations and high-level managers.[47] The *Comité de Negocios Corporatives* (Corporate Business Committee) considers whether the proposed project conforms to CAF policies and business strategy, and is the only review that considers a project's concept and development impact. After proposal development, the project is presented to the *Comité de Préstamos e Inversiones* (Loan and Investment Committee) to analyze the loan's credit risk implications for the CAF's loan portfolio and financial profile. Not only are the review meetings fewer, but the CAF review meetings are much less onerous also, according to a former CAF staffer who has worked at all three MDBs. "Projects are discussed and have to get approved, but the meetings are really fast and not nearly as serious as the IADB and the World Bank" (CAF interview, June 1, 2009). As well, several staffers noted that authority is much more decentralized than in the other MDBs, with officials in country offices permitted greater decision power without having to get approval from headquarters in Caracas.

The CAF has greater flexibility in both arranging and modifying loans than the other MDBs. Loans can be initiated or sped up by direct communication between a country's politicians and CAF management, according to the former CAF staffer. "It's much easier to influence the CAF than the IADB or the World Bank. The president of Ecuador can call the president of CAF and arrange things. Everything is much more negotiable" (Ibid.). Loan modifications are also considerably easier. For example, if a country's financing costs were to drop, the CAF is willing to allow the country to repay more expensive loans and renegotiate new loans on better terms. One operations staffer said, "The countries don't feel that they are tied to expensive financing terms. It's more difficult with the other two, when they sign a contract it's a lot stricter" (CAF interview, August 23, 2011). By contrast, the World Bank requires board approval even for changes in development objectives, and changes to financial terms of World Bank or IADB loans require negotiation of an entirely new loan.

[47] The CAF's formal loan approval process is not publicly available. This process was confirmed by three separate interviews (CAF interviews May 25, 2009; August 23, 2011; August 24, 2011).

Final approval of loans is also radically different at the CAF compared to the World Bank and IADB. Sovereign loans below $20 million can be approved directly by operations vice-presidents and sovereign loans below $75 million can be approved directly by the executive vice-president, with no further review, according to a top-level CAF manager (CAF interview, August 24, 2011)—an authority delegated to management unimaginable at the other two MDBs. As well, the executive board itself is a group of finance ministers and central bank governors who meet only three to four times per year, rather than a permanent sitting board. Because they are top-level officials, the manager said, they can take major decisions quickly without having to consult with their capitals, as executive directors at the World Bank and IADB (Ibid.).

All CAF staffers interviewed, as well as staff and shareholder representatives at the other two MDBs, pointed to the CAF's executive board as a critical characteristic that differentiated it from the IADB and World Bank. According to a top CAF finance officer, "The lack of heavy oversight is for sure a big competitive advantage. Our administration is given more control over day-to-day operations; we don't have a sitting board. This eliminates or reduces almost to zero political interference in our operations" (CAF interview, December 14, 2010). An operations official described the board as functioning "like a club of friends from the same neighborhood—there's no external influence. There are also a lot of ex-ministers and government officials from all the countries on staff, so the board has a lot more confidence in management, they feel well-represented" (CAF interview, August 23, 2011). Long-time CAF President Enrique Garcia, in a 2005 interview, makes much the same point about the relationship between management and shareholders. "I do not have a resident board here. CAF has a board that meets three to four times a year and they are all finance ministers or central bank governors. This means that all high-level decisions are taken very quickly. [Governments] have to delegate to management" (Barham, 2005a, p. 20).

5.2 Environmental and Social Safeguards

A fundamental difference between loans offered by MDBs and those offered by private sources of sovereign credit are environmental and social safeguards. These consist of procedures and restrictions on different types of lending operations meant to “safeguard” the project from having negative impacts, primarily on the environment and on certain social groups that might be affected. All MDBs have some type of safeguards system, although they vary considerably, thus the burden required of borrower countries also varies depending on which MDB they borrow from. This section first compares the current environmental and social (E&S) safeguard framework, and then shows how shareholder interest has shaped their design.

5.2.1 Current Safeguard Framework

The World Bank currently has 10 operational policy E&S safeguards (six related to the environment, two on social issues and two on legal issues) while the IADB has four (two on the environment and two on social issues). The CAF has a list of 14 safeguards (six related to the environment, seven on social issues, and one overarching safeguard), which are not codified into formal policy to the same level as the other two MDBs (CAF, 2007). The most controversial of the safeguard issues relate to environmental impact, involuntary resettlement and indigenous peoples. According to a recent review of safeguard policies by the World Bank’s IEG, these are also the most commonly triggered—72% of investment loans globally between 1999 and 2008 trigger environmental assessments, 30% involuntary resettlements, and 17% indigenous peoples issues (World Bank, 2010a).[48] As such, the comparative analysis below focuses on these three areas. The World Bank safeguards are applied in all operations, hence the discussion below for the World Bank relates not just to Latin America.

A. Environmental Protection

The environmental safeguard policies of the World Bank (OP 4.01) and the IADB (OP 703) are in many respects quite similar. All project teams are to perform an initial screening to determine which “category” a project falls into—A, B, or C—depending on similar criteria for expected environmental impacts. Category A projects are considered to imply the greatest environmental risk, Category B only local impacts that can be

[48] The remaining safeguards are triggered on between 1% and 12% of projects.

mitigated, and Category C minimal or no environmental impacts.[49] On the basis of the categorization, the project team and borrower are then required to follow a number of other steps during the loan approval and implementation process, with more rigorous procedures for Category A projects. Broadly speaking, steps involve undertaking an environmental assessment (EA) for Category A and B projects, engaging in consultations with affected parties (twice for Category A projects), and implementing action plans to mitigate environmental damages.

In a number of key areas, however, World Bank and IADB environmental safeguards differ, with the latter being more flexible and less strict. Both mandate an EA done by the borrower, but the World Bank requires Category A project EAs to be undertaken by "independent EA experts not affiliated with the project" (World Bank, 1999a, para. 4). The IADB's policy makes no mention of who should undertake the EA, meaning it could acceptably be done by an environmental unit within the relevant ministry or by the government's environmental oversight body (IADB, 2007). As well, the World Bank requires Category A project borrowers to "engage independent, internationally recognized environmental specialists to advise on all aspects of the project relevant to the EA" (World Bank, 1999a, para. 4). The IADB "*may* ask the borrowers to establish an advisory panel of experts" (IADB, 2007, p. 24, emphasis added) for Category A projects, but the guidelines explicitly state that "not all category A projects will a priori require and advisory panel" (Ibid., p. 25), leaving a considerable degree of leeway depending on the circumstances.

The IADB's stipulations are also more relaxed regarding consultations with affected people. While both MDBs require consultations for both Category A and B projects, the World Bank specifies that "the borrower consults project affected groups and local non-governmental organizations (NGOs) about the project's environmental aspects and take their views into account" (World Bank, 1999a, para. 14). The IADB requires only that borrowers consult with "affected parties", with no mention of NGOs, adding only that

[49] The World Bank also has a Category FI for projects supported by financial intermediaries with some Bank financing, which the IADB does not include.

consultations with “other interested parties may also be undertaken…” (IADB, 2006b, p. 10). In the case of Category A projects, both MDBs require two sets of consultations, though here again the World Bank is much more specific on exactly when these consultations occur during the project development process (World Bank, 1999a, para. 14 and IADB, 2007, p. 35). The World Bank states that the EA review will give “special attention to, among other things, the nature of the consultations with affected groups and local NGOs and the extent to which the views of such groups were considered” (World Bank, 1999b, para. 12), while the IADB guidelines make no similar statement. During implementation, the World Bank requires borrowers to continue consultations, while the IADB does not (IADB, 2006, p. 10).

The institutional arrangements for EA approval within each MDB also vary, with the IADB project teams afforded considerably more independence compared to World Bank teams, which face oversight at each phase. In the World Bank, the project team is required to work with the Regional Safeguards Advisor—a separate office pertaining to the Operations Vice-Presidency, and not to the country teams—at all stages of the process beginning with the initial screening and categorization, and the RSA can shut the project down at any point if not satisfied for all Category A and B projects (World Bank, 1999b). For the IADB, the team makes its own decision on categorization, and only Category A projects require approval from the Committee on Environmental and Social Impact (CESI) (IADB, 2007). For Category B projects, the CESI will review “only those operations that the Committee considers necessary” (Ibid., p. 25). The EAs produced by borrowers are reviewed only by the project team (Ibid., p. 30-31).

IADB staffers and independent observers concur that while the general environmental directives of the IADB and World Bank are quite similar, implementation is less rigorous at the IADB. One safeguard specialist formerly at the IADB and now at the World Bank noted that a project designated as Category A at the World Bank faces numerous extra mandatory procedures and reviews, while there is little difference at the IADB. “It’s fundamentally different at IADB, there’s really no consequence for administration and timing of categorizing A or B, absolutely no consequence, the process is exactly the same. For us [at the World Bank], there are a lot of processes to go through, there is a difference in level of scrutiny that projects go through here" (World Bank interview, September 6, 2011). Similarly, an independent panel reviewing IADB safeguards stated that safeguard requirements "were often uneven or too general to provide explicit, legally binding guidance to countries and ultimately, to Bank staff charged with supervising compliance" (IADB, 2011g, p. 25-6). A top current environmental staffer at the IADB agreed, noting that the translation of actions listed in the EA into actions by the borrower was lacking. "When we actually looked at the end of that effort, in the execution and supervision, we couldn't find where the requirements were established in terms of an agreement with the borrower," the staffer said. "It's not in the operation plan, it's not even in the loan agreement—it kind of disappeared" (IADB interview, December 7, 2011).

At the CAF, environmental safeguards are contained in a few very short and general paragraphs with essentially no formal obligations put on project teams or borrowers—a far cry from the detailed and lengthy policies and guidelines at the World Bank and IADB. The over-riding principle, as emphasized by the CAF's first safeguard, is that "all projects financed by the CAF conform to the environmental legislation of the country where the project is executed, as well as the international agreements and commitments by shareholding countries" (CAF, 2007, p. 13, author's translation). That is to say, the CAF simply ensures that the country follows its own E&S laws for CAF projects, and places no other external obligation on the borrower. Regarding environmental evaluation, the policy states that the CAF undertakes its own evaluation as part of the normal project cycle, that "when it is considered necessary, [the CAF] requests the presentation of complementary environmental evaluations, studies and analysis…", with no specifics given on content, timing or types of environmental risks (Ibid.). The CAF clearly absolves itself of any responsibility for environmental damages, stating that "It is the responsibility of the client to adopt measures necessary to avoid, control, mitigate and compensate environmental and social impacts and risks" (Ibid.).

As should be evident, while the IADB and World Bank differ to a degree in the rigor of their environmental safeguards, the CAF is several orders of magnitude more lax, leaving almost complete flexibility to assess each project as it chooses. This assessment is supported by an analysis of the CAF by a MDB watchdog NGO. The report points out that the CAF's policies only call for departing from national laws on consulting affected populations or taking measures to safeguard the environment "when it is considered necessary", and "the policies give no orientation to indicate under what conditions the bank could consider it 'necessary' to do so" (Bank Information Center, 2008, p. 14, author's translation). The environmental assessment process, which is a key feature of both IADB and World Bank procedures for high-risk projects, is not formally stipulated in the CAF's policies, and according to the NGO not a single assessment had ever been undertaken up to 2008 (Ibid., p. 17). Further, while the CAF's environmental strategy refers to numerous documents involved in the approval process, none of those documents are publicly available (nor, indeed, does the CAF have any transparency policy regarding public access to information, unlike the other two MDBs).

B. Involuntary Resettlement

When a project has a significant land use component—such as for transport infrastructure, hydropower facilities, or slum upgrading—task teams with the World Bank and the IADB as well as borrowers are required to undertake a number of measures. The resettlement policies of the IADB (OP 710) and World Bank (OP 4.12) are similar in most respects, and as with environmental oversight, differ in a few specific but potentially important details. Project teams in both MDBs are mandated to seek alternative designs that do not involve resettlement, and broadly require compensation and assistance to those who are resettled to achieve a standard of living equal to or better than pre-project levels. The application of the World Bank's safeguard is slightly more broad, encompassing not only resettlements caused directly by the MDB-funded activities (as with the IADB) but also that are "a) directly and significantly related to the Bank-assisted project, (b) necessary to achieve its objectives as set forth in the project documents; and (c) carried out, or planned to be carried out, contemporaneously with the project" (World Bank, 2001c, para. 4).

In designing a resettlement plan, the World Bank requires "meaningful consultations with affected persons and communities, local authorities, and, as appropriate, nongovernmental organizations" (Ibid., para. 14), and that displaced people should be "meaningfully consulted and should have opportunities to participate in planning and implementing resettlement programs" (Ibid., para. 2b). By contrast, the first sentence of the consultations section of the IADB's implementation guidelines for resettlement states that "*Where possible*, the affected population should be involved in the design of the resettlement plan" (IADB, 1999, p. 18, emphasis added). The guidelines then go on at great length to detail why consultations with community authorities and local NGOs can lead to conflicts and might be best avoided, and offers a variety of flexible options for the borrower to take affected people's views into account when designing the resettlement plan depending on local conditions. The World Bank further requires the creation of a third-party dispute resolution mechanism to address grievances related to the resettlement plan (World Bank, 2001c, Annex A, para. 17), which is discussed but not mandated in the IADB's guidelines (IADB, 1999).

On the issue of compensation to affected individuals, both MDBs clearly state the principle of re-establishing or exceeding prior levels of livelihood. However the World Bank policy states that individuals be "provided prompt and effective compensation at full replacement cost for losses of assets" (World Bank, 2001c, para. 6), while the IADB specifies "fair and adequate compensation and rehabilitation" (IADB, 1998, p. 1), providing greater leeway for project teams and governments. Further, the World Bank emphasizes that "Preference should be given to land-based resettlement strategies for displaced persons whose livelihoods are land-based" (World Bank, 2001c, para. 11), while the IADB policy states only that "The options that are offered should be appropriate for the people affected, and should reflect their capabilities and realistic aspirations" (IADB, 1998, p. 4), again providing considerably more flexibility (especially as finding new land on which to resettle people whose livelihoods are land-based is often extremely difficult). The World Bank policy also specifically addresses the issue of people who may lose access to natural resources due to restrictions involving parks or protected areas and mandates further consultations (World Bank, 2001c, para. 7), whereas the issue is not discussed in the IADB policy.

In overseeing resettlement issues, the World Bank team must work with the regional social development unit, the Legal Vice-Presidency and a special Resettlement Committee, all of which must review and approve borrower actions (World Bank, 2001d). Once under implementation, the project is "not considered complete—and Bank supervision continues—until the resettlement measures set out in the relevant resettlement instrument have been implemented" (Ibid., para. 16). For the IADB, the project team essentially has to pass one hurdle—the submission and approval of an Environmental and Social Impact Report by the Committee on Environmental and Social Impact (CESI), after which it moves into the regular project channels of the Loan Committee and the Board for final approval (IADB, 1999). While the resettlement commitments of the borrower are incorporated into the loan agreement, they are not in the legal agreement, unlike the World Bank (Ibid.). The IADB's policy guidelines discuss supervision procedures for resettlement at some length, but make no categorical statement like the World Bank policy that project completion depends on resettlement completion (Ibid.).

Evidence from internal World Bank analysis supports the conclusion that its resettlement policies are more stringent than other MDBs, including the IADB. A study of safeguard compliance in 2000, discussing a recent revision of the resettlement policy, noted that "Compared to the safeguard objectives of other MDBs and Part I countries, the above policy appears to set higher standards and increases potential for external criticism of the Bank and borrowers…" (World Bank, 2000, p. 24). The report adds that "In some instances, [resettlement policies] would exceed normal practices in industrial countries" (Ibid, p. 12). A more recent IEG study from 2010 came to a similar conclusion, quoting one World Bank country director as saying, "There is a serious disconnect between what countries are doing and our social safeguards. The resettlement policy is way out of line with what our clients have" (World Bank, 2010a, p. 93). The IEG specifically compared the World Bank's policies with the IADB's, and concluded that the latter was more flexible and project-specific (Ibid.).

The CAF's safeguard regarding resettlement states the same over-arching principles as the other two MDBs, but contains no specific requirements whatsoever. The policy states simply that in the case of projects requiring resettlement, the CAF "requests the formulation of plans that compensate or offer similar or better conditions of life to affected groups, and that receiving communities are taken into account" (CAF, 2007, p. 15, author's translation). The policy further says that the CAF "supports developing skills and options for local community development, especially for indigenous people who, due to their vulnerable condition, could be directly affected by an operation" (Ibid.).[50]

C. Indigenous Peoples

The policies on indigenous people for the World Bank (OP 4.10) and IADB (OP 765) are, once again, very similar, both in terms of the comprehensiveness of their coverage and in the requirements to project teams and borrowers. As with environmental and resettlement safeguards, the IADB appears to be somewhat more flexible in certain respects, but unlike the other safeguards, indigenous policy for the IADB also exceeds World Bank requirements in at least one area, which may point to political economy considerations specific to the Latin America region.

A first important difference is the definition of indigenous peoples themselves. Because of the region's historical background, the IADB can simply define indigenous people as descendents of the inhabitants before the conquest who "retain some or all of their own social, economic, political, linguistic and cultural institutions and practices," and who consider themselves to be indigenous people (IADB, 2006c). The World Bank—which obviously works across the globe, not just in Latin America—is forced to recognize right

[50] "Support" is the author's translation of the Spanish word "*propende*", which has no good translation to English, but suggests a tendency or propensity toward a certain action, and is hence actually even weaker than "support."

at the beginning of its OP that "because there is no universally accepted definition of 'Indigenous Peoples,' this policy does not define the term" (World Bank, 2005b, para. 3). It then proceeds to set out a series of characteristics to be used to identify indigenous peoples that are considerably vaguer than for the IADB which, one can imagine, must lead to considerable dispute in many parts of the world. A 2000 World Bank study on safeguards mentions one project where it took six months to even decide if a given group was "indigenous" (World Bank, 2000, p. 11). The World Bank further explicitly states that groups that might have once had a "collective attachment" to an area, but because of "forced severance" no longer live there, are also eligible under the policy (World Bank, 2005b, para. 4).

Both MDBs place considerable emphasis on obtaining the free and informed consent of affected indigenous peoples before moving ahead with the project and in the design of an indigenous peoples plan to mitigate impacts (Ibid. and IADB, 2006c). However the IADB further notes that the "expressed refusal by indigenous people to participate in consultations represents a significant risk for the project, and project approval will require a waiver of those requirements from the Bank's Board of Executive Directors" (IADB, 2006c, para. 2.53a). The World Bank's OP simply states that the project cannot proceed unless the task team is able to ascertain that "broad support" for the project exists (World Bank, 2005b, para. 7). The IADB also goes further than the World Bank in requiring "socioculturally appropriate and technically feasible mechanisms for the participation of affected indigenous peoples in the monitoring and evaluation" of the project and of mitigation measures (IADB, 2006c, para. 2.39d). The World Bank requires only that the project task leader "ensures that Bank supervision includes appropriate social science and legal expertise" (World Bank, 2005c, para. 12).

In terms of bureaucratic process, the two OPs generally mirror those related to environmental assessment. The World Bank project team must receive approval from the regional safeguard advisor at all steps in the process, as well as the legal department (Ibid.). The IADB relies on the project team at most steps of the process, with clearance required for the initial social evaluation and the indigenous peoples plan by the CESI.

Final obligations are required by the IADB to be included not just in the project documents, but also in the legal, contractual documents, unlike the situation with resettlement plans (IADB, 2006c). The World Bank has a similar requirement (World Bank, 2005c).

The CAF, here again, has the same type of vague safeguards for indigenous people as in environment and resettlement issues. The safeguard re-emphasizes the priority of following national law, stating in the second sentence that the CAF "is vigilant that operations have adequately completed the participation process required by the laws of the respective country," adding that "when considered necessary" the CAF will "request" additional public consultations and management plans on indigenous groups "recognized by the respective national legislation" (CAF, 2007, pp. 14-15). The Bank Information Center report on the CAF notes that it had no specialist on indigenous issues on its staff as of 2008 (Bank Information Center, 2008).

5.2.2 Summing Up and Linking to Shareholder Interest

As with other non-financial aspects of the three MDBs analyzed in this chapter, their policies related to E&S protection falls on a continuum, with the World Bank generally at one end, the IADB in the middle and the CAF at the other extreme (Table 5.2). The evidence clearly indicates that this is a function of shareholder interest and balance of power in each MDB's governance.

Table 5.2. Comparison of Three Safeguards

	World Bank	IADB	CAF
Environment			
Experts	Independent experts for EA and Category A advisory panel	No stipulation; advisory panel not required	National systems
Consultations	Includes NGOs	Only "affected parties"	National systems
Bureaucracy	Separate regional safeguard team (often conflicts with project team)	No separate safeguard specialists – project team makes decisions	Ad hoc review as part of regular loan approval
Resettlement			
Trigger	Caused by or related to project	Directly caused by project only	National systems
Consultations	Required	"Where possible"	National systems
Dispute resolution	3rd party mechanism required	Not required	National systems
Type of resettlement	Land-based preferred for those with land-based livelihoods	"Appropriate" resettlement	National systems
Bureaucracy	Social Development Unit, Resettlement Committee, Legal	Only project team	Ad hoc review as part of regular loan approval
Project completion	Not until resettlement completed	No requirement	No requirement
Indigenous Peoples			
Definition	Vague, open to dispute	Descendents of pre-Hispanic population	National systems
Consent	"Broad support"	Expressed agreement required	National systems
Supervision	Includes social science and legal advice, no indigenous participation required	Socioculturally appropriate mechanisms to ensure indigenous participation required	National systems
Bureaucracy	Regional Safeguards Unit Committee, Legal	Project team only	Ad hoc review as part of regular loan approval

A. World Bank

The World Bank is the most inclined to place restrictions on its lending practices that go well beyond what national laws of borrowing countries (and indeed non-borrowing countries, in some cases) stipulate, and is the most willing to put in place bureaucratic hurdles to ensure that those policies are strictly followed. This is evident in each of the three E&S safeguards reviewed above, and is substantiated by internal World Bank studies. A 2000 assessment of the cost of doing business with the World Bank stated, "In their actual implementation, Bank policies are perceived by clients to be more rigorous than those required by other sources of development finance…Many other MDBs have more flexible guidelines where the Bank has formal policies, and in general have fewer staff and internal capacity to support implementation of the guidelines" (World Bank, 2000, p. 2). Similarly, a 2010 survey of country government officials undertaken by the World Bank in 2010 found reported that 73% said overall World Bank safeguards are significantly stronger than projects financed by other institutions (World Bank, 2010a).

Numerous sources indicate that the force behind this drive for strict E&S safeguards at the World Bank is the interests and voting power of non-borrowing shareholders, who implement these policies against the interests of borrowing countries, and institute rigid, legalistic procedures that limit the staff's flexibility. The two most comprehensive reviews of the creation of safeguards at the World Bank both document in exhaustive detail how activist NGOs brought pressure to bear on the World Bank via the U.S. Congress and political parties in western Europe (mainly Germany and the U.K.), which led to the implementation and continual tightening of safeguards in the 1980s and 1990s against the vocal opposition of borrowing countries.[51] Not only did the campaigns force the World Bank into implementing much more rigorous environmental and social standards than had previously been the case, but the lack of trust of World Bank staff on the part of many non-borrowing shareholders led to the creation of the Inspection Panel in 1993 as part of IDA 10, as a watchdog that safeguards were followed (Wade, 1997 and

[51] The two most thorough accounts—though with rather different perspectives—are Wade, 1997 and Shihata, 1991, 1995 and 2000.

Shihata, 2000). “External criticisms of the Bank by NGOs and influential circles in certain member countries with large subscriptions in the Bank’s capital (and large subscriptions/contributions to the Bank’s affiliate, the International Development Association (IDA)) no doubt influenced that conclusion” (Shihata, 2000, p. 540).

Executive directors from both borrowing and non-borrowing countries said in interviews that the latter were unquestionably the main force pushing for tighter environmental and social safeguards, largely as a result of pressures they face from civil society. One Latin American middle-income AED stated that “It all comes from developing countries—the Nordic chair generally pushes a lot about performance standards, France and Germany also push, and the United States too depending on the project” (World Bank AED interview, December 14, 2011). The Brazilian ED agreed, saying “If I’m from a non-borrower country, I want to put that in an ex-ante conditionality, safeguards so strong that no one has access unless they comply with safeguards, which are for developed countries not for developing countries” (World Bank ED interview, December 12, 2011). An advisor to European G7 ED said that “We get a lot of lobbying about environmental and social human rights safeguards,” and added that tighter safeguards are resisted by many borrowers. “Some MICs [middle-income countries] definitely say this isn’t the way we should be going about our business. They think that for growth and private sector growth to take the place, they should get that damn infrastructure in and let it do the work, and that all safeguards are doing is putting grit in the machine” (World Bank ED staff interview, January 30, 2012).

B. *IADB*

The IADB’s safeguard policies are in most respects very similar to the World Bank, although they have tightened at a slower pace. A top environmental staffer at the IADB referred to safeguard policies in the early 2000s as “very broad statements, not very definitive, more aspirational and giving a general sense of warm feelings about environment rather than a rigorous, defined set of practices and commitments” (IADB interview, December 7, 2011). E&S safeguards were thoroughly revamped starting in

2003, bringing them much more in line with World Bank (IADB, 2006b), driven almost entirely by the non-borrowing shareholders. "It was the U.S. and the other donors, no question about it," according to the environmental staffer (IADB interview, December 7, 2011). As a result of the new policies, the number of policies going through safeguard compliance review jumped from 480 in 2007 to 775 in 2009 (IADB, 2011g). Pressure from non-borrowers continues to ensure that safeguards are followed. The AED of a European G7 non-borrower commented, "I can't see any non-borrowing country wanting to weaken safeguard procedures. That's the basis on which the Americans can support a capital increase" (IADB AED interview, January 31, 2012). Indeed, the U.S. Treasury's report to Congress in 2011 justified its agreement to the most recent capital increase in part by noting that its requirement for the IADB to revise E&S safeguards had been complied with (U.S. Department of Treasury, 2011).

A new independent inspection panel was also created in 1994 at the behest of non-borrowers, following the lead of the World Bank, although it was initially a rather toothless instrument. As one observer noted, "Created under U.S. pressure during negotiations of the IDB's eighth replenishment, the panel has been little publicized in the region and suffers from 'obscurity and a lack of independence from IDB control'" (Nelson, 2000, p. 424). The author specifically cites the greater power of borrowing shareholders at the IADB vis a vis the World Bank as the reason for this. Between 1994 and 2010, the IADB's Independent Investigation Mechanism received a grand total of five complaints, compared to 70 by the World Bank's Inspection Panel over the same time period (World Bank, 2010d). Under pressure from the U.S. and other non-borrowers[52] as part of the ninth capital increase, the IADB completely revamped the panel. The U.S. Treasury's report to Congress in 2009 noted with satisfaction that "with the strong support of the United States," the new panel "significantly improves the IDB's recourse mechanism by increasing its independence from management" (U.S. Department of Treasury, 2010b, p. 9).

[52] The IADB governors for Norway (Olav Kjørven), German (Uschi Eid), and Japan (Yuji Yamamoto) expressed support for strengthening the inspection panel (now called the Independent Consultation and Investigation Mechanism) in speeches at the 2004 Board of Governor meetings in Lima, Peru. It was not mentioned by governors from any borrowing country recorded at the event. See IADB, 2004.

Despite the many similarities with World Bank safeguard policies, the IADB has a marked tendency to less formalistic rules in a way that offers more flexibility to both staff and borrowing countries. The greater power of borrowing shareholders and the more consensual atmosphere of IADB governance—necessitated by the more balanced voting shares between borrowers and non-borrowers—means client countries are able to shape the implementation of these policies in a way that better suits their interests. A researcher examining World Bank and IADB policies on civil society influence came to the same conclusion on the how the two MDBs compare: "There is a discernible pattern in nearly all areas of governance and civil society policy: World Bank adoption of a policy precedes the IDB's and creates a standard…The IDB adapts and revises the World Bank's global approach in ways that reflect the attitudes of regional governments toward the new policies" (Nelson, 2000, pp. 419-20) The resulting "loosely framed policy reduces opposition and leaves broad discretion with the IDB's country offices and borrowing government officials" (Ibid., p. 420). Staffers and EDs agree with this overall assessment. One European G7 AED defended the IADB's safeguards as robust, but acknowledged their flexibility: "We are probably less legalistic than the World Bank" in safeguard implementation (IADB AED interview, January 31, 2012). A top environmental staffer echoed this view: "Compared to the World Bank, we are less procedural—it's more about the outcome. We wanted some flexibility, it fits the institutional culture better" (IADB interview, December 7, 2011).

The one exception to this overall pattern relates to the safeguards for indigenous people by the IADB, which are somewhat stronger than the World Bank's. This reading of the policies is substantiated by interviews with staffers. One safeguard expert who has worked at all three MDBs attributed this to the particular political influence of indigenous groups in the political systems of many countries in Latin America, compared to the rest of the world. "Indigenous groups in Latin America have been very vocal and very political, and have gained power at the government level…In countries like Venezuela, Colombia, Peru, Bolivia, Brazil, Mexico, there's a very strong influence of indigenous people. Chile has incredible rules for IPs [indigenous peoples]. It's a political force that you cannot ignore" (World Bank interview, September 6, 2011). Hence, because of very strong existing legislation and constitutional protections in many Latin American countries on indigenous rights, borrowing governments do not feel threatened by strict IADB safeguards in this area, and in fact may find them politically useful.

C. CAF

In contrast to the other two MDBs, the fact that borrower shareholders control the CAF ensures that it imposes no binding external constraints on environmental and social aspects of project lending, beyond respect for national laws. The CAF first formally published an environmental strategy only in April 2007. According to the document, the CAF created a Sustainable Development Coordination Office as far back as 1994, which in 2004 became the Vice-Presidency of Social and Environmental Development. But by the accounts of former CAF officials as well as an independent NGO report (Bank Information Center, 2008), the CAF had essentially no safeguards at all until the 2007 policy statement, and arguably still does not. A top CAF environmental specialist who left in the early 2000s to work at other development institutions said flatly, "When I was there, the CAF didn't have any environmental policy" (World Bank interview, September 6, 2011). The specialist said that the CAF had made some improvements in the last 15 years, but that "In terms of commitment, depth of analysis and seriousness about how to manage environmental and social aspects, the CAF is definitely the lighter one" (Ibid.). Staffers at the CAF defend the environmental policies as respectful of local laws. "We go with the local legislation, we don't ask more…We feel that if you are respecting local laws and doing your work, you don't have to go further than that," said one CAF operations staffer. "We don't go to the extremes as others in ways that would make the CAF more expensive and complicated" (CAF interview, August 23, 2011).

CAF staffers point to the difference in shareholder composition as the fundamental reason for the variance in policies. "The reason is fundamentally from the composition of the board. If for example we had Nordic and European countries on our board, environmental issues are very important to them, the bar is a lot higher…At end of day, since this is a Latin bank, for the board to put on conditionality that is stricter than local laws would be to shoot themselves in the foot, because they would be requiring expensive conditions that they have to pay themselves," according to an operations staffer (Ibid.). A management-level policy staffer concurred, saying that the CAF's environmental and social policies "are not imposed from the outside by third parties, they are Latin American policies designed for this context… Our policies are not from environmentalists from some other country, they don't respond to the policies of non-borrowing countries like the other banks" (CAF interview, August 24, 2011). An IADB environmental official agreed that governance played the fundamental role in shaping the different policies. "It's because the board membership completely different. There's no European, North American or Japanese shareholders in the CAF, which are the countries that tend to raise these concerns" (IADB interview, December 7, 2011).

5.3 Procurement Safeguards

While E&S safeguards have a relatively high degree of visibility, financial safeguards on MDB lending receive considerably less public attention but are a major source of non-financial costs faced by borrowing countries. As one internal World Bank study noted, procurement and financial management requirements apply to almost all operations, whereas environmental assessments take place on about half of investment operations and resettlement on about 25 percent (World Bank, 2001b, p. 9). Procurement rules govern how the proceeds of loans may be spent by recipient governments—that is, the procedures by which the government selects and pays the providers of goods and services needed for the completion of a project—while public financial management (PFM) regulates the flow of resources through government bank accounts, audit procedures and the like. As with other safeguards, procurement and PFM policies on World Bank and IADB loans supersede any national legislation or procedures in these areas.

Interviews with financial safeguard specialists and operations staffers at both the IADB and World Bank point to procurement as a much more contentious issue between borrowers and MDBs, compared to PFM policies. "PFM is just about the systems for moving the money, and every country has those," said a World Bank financial safeguard specialist. “That part of our work is kind of a relief for the countries. Procurement is a lot more difficult, because it involves national legislation and legal interpretation” (World Bank interview, April 24, 2012). An IADB procurement official agreed, saying “Definitely procurement is more difficult for the countries, because it has to get done before the project moves, everything else [PFM] is after the fact. There’s many layers of challenges with procurement, and governments have a real fixation on it” (IADB interview, April 27, 2012). This view is supported by the fact that in 20 interviews with World Bank and IADB shareholders discussing financial safeguards, attention was focused entirely on procurement, and PFM was not raised a single time as a political issue. As such, this section will focus on procurement.

Accounts of staffers and EDs and a review of policy documents indicate that the procurement safeguards for the World Bank and the IADB are very similar. A World Bank procurement specialist, who previously worked at the IADB in harmonizing procurement policy among MDBs, said, “We are 98% similar in every aspect. There’s some differences in how certain words like corruption and fraud are defined, but they are minor, and we have a group working on harmonizing this right now” among the World Bank, IADB, Asian Development Bank, African Development Bank and European Bank for Reconstruction and Development (World Bank interview, April 24, 2012).

The IADB was forced by the U.S., with the backing of European shareholders, to simply adopt the World Bank’s procurement guidelines wholesale in the mid-2000s, as were the other regional development banks. Procurement staffers at both the IADB and World Bank concurred that the U.S. and Europeans insisted that the IADB use the World Bank standards, and used their leverage on an upcoming capital increase negotiation to force the issue. “The U.S. said, ‘if you don’t take the World Bank’s policy on this, we won’t agree to the next capital replenishment.’ And the Europeans backed the Americans, so we did it,” according to a current World Bank and former IADB procurement specialist (World Bank interview, April 24, 2012). An examination quickly makes clear that the relevant procurement guidelines for the World Bank and the IADB are, in fact, almost word-for-word copies of one another (World Bank, 2011d and IADB, 2011h). The bidding documents have been the same for the IADB and World Bank—as well as the other major regional MDBs—since 2005. Rules on which types of expenditures must be bid, which types of loans require using procurement guidelines, cut-off values requiring international competitive bidding are the same for both banks. As well, the World Bank and the four major regional MDBs have an agreement by which a firm found to have engaged in improper practices at one MDB is barred from bidding on contracts in another MDB.

According to the World Bank procurement specialist, borrowing government officials are constantly demanding to know why they must follow these rules instead of their own national systems. "They say, 'we have our own laws, why should we follow your procedures?' So I have to explain that the country signed an international treaty and they are members of the World Bank, so these rules take precedence over national law. It's always a long process" (World Bank interview, April 24, 2012). A long-time staffer in the World Bank's Operations Policy division said he had experienced similar complaints in Latin America. "A country like Mexico has their own procurement laws, which they think are quite good. To a large extent the Bank thinks they are good too, but the board has resisted country systems for procurement" (World Bank interview, September 7, 2011). The IADB procurement specialist offered a similar critique, saying that borrower countries strongly object to the imposition of outside rules when they already have functioning procurement systems (IADB interview, April 27, 2012).

The over-riding importance of procurement policy to the U.S. and its veto power over capital increases, coupled with the support of other non-borrower shareholders, has meant that the greater influence of borrower countries at the IADB has not translated into less stringent procedures faced by borrowers. "It's basically the U.S., they think that [procurement controls] will help their interests, help their business to compete for contracts," said one top IADB policy staffer. "Japan is also involved. It's a consistent worry by non-borrowers that transparent and competitive procurement rules have to be applied. The U.S. has been more vocal on the fact that the MDBs have to have their own procurement policy without country systems" (IADB interview, January 18, 2012). A

European G7 shareholder AED at the IADB said national lobbies also pushed him to support procurement standards, but he concurred that the overwhelming pressure came from the U.S. “This is an action taken by the U.S. across the board in all MDBs to say, ‘that’s a red line for Congress.’ I think the issue is that as part of the pitch to sell multilateralism to Congress, the U.S. has to say ‘for every dollar we put in to these multilaterals, we get seven back for U.S. Inc.” (IADB AED interview, January 31, 2012).

Despite this overwhelming interest of the dominant non-borrowing shareholder on procurement, there is evidence that even here the IADB is able to make safeguard compliance more flexible than at the World Bank. When asked if borrowers would see any difference at all between the World Bank and IADB in procurement, the World Bank procurement specialist who has worked at both MDBs said without hesitation, “The implementation. It’s the same set of rules, but World Bank implementation is more rigid, and the IADB is more flexible in how to implement those rules. That’s why there’s a clear preference with the IADB for the countries in the region” (World Bank interview, April 24, 2012). The IADB procurement official agreed, saying that their application of the rules was less legalistic than the World Bank, and that as a result countries preferred to work with the IADB (IADB interview, April 27, 2012). This view was supported by Latin American borrower shareholders at both the IADB and World Bank, all of whom said that the World Bank was much more obsessed with rigidly following procedure than the IADB.

The contrast between the World Bank and IADB, at one end of the continuum, and the CAF at the other, is if anything even more stark regarding procurement than in any other area of lending policy. The CAF, simply put, has no procurement or financial policies whatsoever—once the country is granted a loan, it is free to spend the resources as it sees fit. A top CAF policy manager stated, “The only procurement rule we have is that countries follow their own legislation. We don’t have any of the types of procurement policies that cause problems with the IADB and the World Bank, which come from the interests of donor countries. In the other banks, the European countries that are shareholders, or the U.S., they have an interest that their companies can bid on projects, but in the CAF we don't have that" (CAF interview, August 24, 2011).

5.4 Impact of Non-Financial Policies on Borrowing

The above analysis of three key aspects of non-financial lending policies in all three MDBs suggests a relatively clear continuum from the point of view of borrowing countries: the World Bank's policies are clearly the most onerous, the IADB's similar but with a greater degree of flexibility, especially in implementation, and the CAF's rely entirely on the laws and procedures used by each country, with no external imposition.

The key question then arises: are these characteristics in part responsible for the evolving patterns in lending analyzed in Chapter 3? Evidence suggests that the answer is yes. To substantiate that claim, this section makes the causal link between MDB characteristics and lending patterns based on evidence from interviews with staffers and EDs, speeches by country representatives, as well as reports by the MDBs themselves. The question is then addressed further in the next chapter through interviews with actual government officials involved in borrowing from MDBs.

Unquestionably, the decision to take out a loan from an MDB is extraordinarily complex and involves a multitude of factors that cannot be fully controlled for, including a country's own economic and political situation, the availability and price of MDB funding compared to other sources of sovereign funding, the personal relationships between government ministry officials and MDB staffers, quality of technical assistance and the conjunctural interests of powerful MDB shareholders. But there seems to be little doubt that, all else being equal, the non-financial characteristics discussed above lead countries to prefer the IADB to the World Bank and the CAF to the IADB.

5.4.1 Overall Hassles Impacting Lending Demand

The clearest evidence of the impact of World Bank safeguard and bureaucratic impositions on lending comes from concerns of World Bank management itself, as evidence by the Cost of Doing Business Task Force launched in the early 2000s to address these problems. The Task Force report states that "The Bank has more favorable lending terms than the five Multilateral Development Banks (MDBs). At the same time, Bank safeguard and financial requirements and other business practices tend to be more comprehensive, more stringent and more consistently enforced and are perceived by clients to add costs" (World Bank, 2001b, p. 10).

Despite the efforts of the Task Force to address bureaucratic limitations, little has improved in the intervening decade. A 2010 study by the World Bank's IEG found that environmental, social and financial safeguards clearly limited lending. "The impact of this chilling effect was reported by a majority of team leaders from Latin America and the Caribbean and over 40 percent from East Asia and Pacific and South Asia" World Bank, 2010a, p. 46). Some 60% of Latin America task team leaders reported client avoidance of World Bank projects or components because of safeguards (Ibid.). A survey found that 72% of safeguard staff had encountered situations where the client government wanted to avoid dealing with the Bank on a project because they considered that social safeguard requirements might be too expensive or time consuming, while a further 55% said the same question regarding environmental safeguards (Ibid.).

While safeguards and bureaucracy are impacting the overall desire of countries to borrow from the World Bank and (to a lesser degree) the IADB, the impact is particularly strong in major infrastructure projects, such as building roads, urban transit, energy plants and the like. These types of projects—which were the overwhelming focus of World Bank activities until the mid-1980s—are now seen as particularly complicated due to the likelihood of triggering environmental and social safeguards as well as the increasing complexities of procurement rules. The 2001 Cost of Doing Business Study found "feedback from clients that the willingness of IBRD borrowers to pursue Bank lending for certain kinds of infrastructure—electric power, dams, slum upgrading, transportation—is affected by the clients' desire to avoid the costs and hassles of certain safeguard policies. Given other opportunities for financing, IBRD borrowers articulated an explicit hierarchy of preference for official borrowing in these infrastructure subsectors: domestic resources, bilateral donors, Regional Banks and lastly, the World Bank" (World Bank, 2001b, p. vii).

This sentiment was echoed in several speeches to World Bank annual meetings. In 2006, for example, Peruvian Finance Minister Fernando Zavala said that "new restrictions have appeared, such as the stringent social and environmental safeguards promoted by the IFIs, which have practically paralyzed investments in large dams" (World Bank, 2006a). A top IADB environmental staffer related a recent story about Brazilian plans for two major hydroelectric plants. "There was a point when some folks at the IADB were trying to court Brazil to finance that project, and the immediate response from the Brazilians was, 'Not on our life, you'll come running in here with your safeguards,'" the staffer said. "In another project, in Ecuador, they wanted to divert a river in a UNESCO Biosphere Reserve, which would have killed the river for 27 kilometers. The Ecuadorans said, 'We don't want to deal with your safeguards, we can just have the Chinese finance this'" (IADB interview, December 7, 2011).

While the IADB's safeguards and procedures are somewhat less onerous to borrowers than the World Bank's, both MDBs are considered much more difficult to work with than the CAF. "This is definitely an advantage for the CAF," said the Argentina IADB ED. "The safeguards impose extraterritorial legislation on the countries. You don't want to have a parallel legal system short-circuit the decisions in your own legal system" (IADB ED interview, January 13, 2012). The Brazilian ED in the IADB expressed the same attitude, and said his country would much prefer to use the CAF or bilateral funding sources for major infrastructure projects such as hydroelectric dams due to their use of national legislation (IADB ED interview, January 10, 2012).

This flexibility and speed of the CAF compared to the other MDBs, derived from the structure of its shareholding, is seen by the organization as a key asset that helps explain why its lending has grown so rapidly in recent years. A top CAF policy staffer stated, "I think the agility and rapidity of the CAF vis a vis the other banks is a competitive advantage and it does partially compensate for the higher cost of our loans. Political cycles are short in Latin America, usually four years, and authorities want to see the results of their projects quickly. The fact that the CAF can react so much faster than the others is a major advantage" (CAF interview, August 24, 2011). The former operations staffer now at the World Bank agreed. "The CAF cannot compete in terms of price, because it doesn't have the rich donor countries behind it and it has a higher cost of borrowing to pass on. So instead it competes on speed and easy conditions. If a country needs a loan, the CAF can deliver it a lot faster, without a lot of safeguards and with much more convenient conditions. This is why the CAF is growing so rapidly" (CAF interview, June 1, 2009). A top IADB Treasury official, discussing the reasons behind the CAF's sharp increase in lending, agreed that non-financial characteristics are key. "One of big advantages [of the CAF] is that there's not the same environmental oversight and other requirements that we have to satisfy for each of our loans. They can pretty much write a loan and make out a check. We have to abide by desires and requirements of shareholders, meet conditions for gender issues, indigenous issues, environmental issues—the CAF doesn't have the same requirements. For some countries, it's definitely worth paying extra to avoid those hassles" (IADB interview, November 15, 2010).

5.4.2 Hesitant Moves Toward Reform

Since the mid-1990s, a series of initiatives at both the World Bank and the IADB have attempted to reduce the bureaucratic burden facing client countries. One World Bank policy staffer who has been involved in various of these efforts since the early 2000s put the reasons behind them succinctly: "All these MICs [middle-income countries] have alternative sources of financing, and some just won't put up with extra processing requirements. The idea is to recapture that clientele" (World Bank interview, October 4, 2011). This directly links to Hypothesis 3 of this study—the World Bank and IADB are not simply sitting passively as these bureaucratic procedures impact their lending, but are instead actively attempting to improve their competitiveness to ensure continued demand for their loans. However, this drive—coming mainly from MDB staff and supported by borrowing shareholders—has been largely stymied by the resistance of non-borrowers. Efforts to implement what are broadly termed "country systems"—that is, using a country's own laws and procedures instead of MDB safeguards—have been limited at best.

The proliferation of different financial and procurement systems required by recipient countries for aid and development lending, and the negative effect this has on recipient administrative overload and limiting institutional development, was a key aspect of the Paris Declaration on Aid Effectiveness in 2005. The U.S. and other major donor countries, as well as 26 multilateral organizations including the World Bank and IADB, agreed in 2005 as part of the Paris Declaration principles to move toward greater use of country systems in procurement, financial management and E&S safeguards (OECD, 2012). At the World Bank, this led to the country systems pilot program, wherein staff was given the green light to attempt to qualify the systems of 10 countries around the world for use in World Bank projects (World Bank, 2010e).

In the discussion of country systems, borrower country representatives at the World Bank annual meetings in 2005 and 2006—when the issue was on the agenda—voiced strong support. For example, Peruvian Finance Minister Luis Carranza stated, "We think that country systems are a good starting point to move toward simpler institutions in the areas where external rigid standards have been imposed upon these countries. We are referring to the rigid social and environmental safeguard policies, the sophisticated results-based framework, and the donor-driven monitoring and evaluation systems" (World Bank, 2006b). Speeches from non-borrower representatives, however, were considerably less sanguine. U.S. Treasury Secretary John Snow said his country looked "with concern at efforts to rush to use country systems that do not meet the highest international standards" (World Bank, 2006a). Similar statements of caution, expressing fears that country systems could weaken Bank fiduciary and environmental safeguards, can be found in speeches by representatives of Switzerland (World Bank, 2004b), Germany (World Bank, 2005c), the Nordic countries (World Bank, 2006b) and Canada (World Bank, 2007c), among many others.

In the end, the restrictions imposed on the pilot program by non-borrowers ensured its failure. A World Bank procurement staffer in Latin America said, "We picked Brazil, Colombia and Panama, and none of them meet the minimum requirements. So we couldn't apply whole country systems. At the end of the day they [the countries] considered that the whole thing was not worth it" (World Bank interview, April 24, 2012). One European ED at the World Bank commented that the country systems design was so complex that it was easier for borrowers to simply use World Bank standards (World Bank ED interview, January 25, 2012). A 2010 IEG report on safeguards came to a similar conclusion. "…client expectations that Bank safeguard responsibilities would be transferred to the borrower did not occur. Management clarified that this was never the intention of the pilots" (World Bank, 2010a, p. 85). One could forgive borrowing countries from wondering what the intention was, then.

Quick on the heels of the failure of the country systems pilot, the Program for Results (P4R) lending instrument was designed and approved for pilot testing on January 24, 2012. The aim of P4R is to tackle the same problem in a different way, by having the World Bank reimburse client countries for expenditures already undertaken, if the agreed results have been achieved. However, early evidence suggests that the same tensions that plagued the discussions on country systems are likely to severely limit the use of P4R. All borrower and non-borrower World Bank EDs and several staffers interviewed stated that numerous restrictions had been placed on the instrument, mainly at the behest of the U.S. with the support of several other non-borrowers. As a result, many types of lending projects are excluded from P4R, and the instrument has been capped at 5% of World Bank lending. The U.S. ED confirmed that his country specifically pushed for this limit to the initial rollout of P4R. "It does raise a number of concerns. Is that country system capable of protecting against corruption, insuring the environmental standards are met, can it handle it? Let's make sure it works" (World Bank ED interview, January 30, 2012). Further, countries will still be required to demonstrate that they are complying with safeguards equivalent to the World Bank's. In the end, the gains of the new instrument appear questionable at best, held back once again by the refusal of non-borrowers to ease bureaucratic and safeguard restrictions.

“There’s a lot of resistance [to P4R], particularly by the U.S. ED, and discussions around capital increase are being tied to this,” according to one operations policy staffer. “The U.S. said they won’t support the capital increase if this goes ahead in a way they don’t like…The Germans were very negative as well” (World Bank interview, January 12, 2012). The Brazilian ED concurred, saying that the U.S. and other non-borrowers were not willing to give up control over safeguards and procurement because of their mistrust of borrower countries (World Bank ED interview, December 12, 2011). And, as with the discussion of procurement above, the interests of companies from non-borrower countries has played a role. An operations staffer involved in developing P4R pointed to business lobbies from non-borrower countries as a strong force lobbying against P4R, specifically because of fears that they might lose access to contracts if countries did not use World Bank systems (World Bank interview, January 12, 2012).

A similar process has been underway at the IADB. A country systems pilot was introduced in the IADB at about the same time as the World Bank, which has only began moving ahead recently. Chile’s financial and environmental safeguards have undergone a lengthy process of inspection by the IADB, and its systems were approved at the end of 2011. Colombia and Brazil are due to be taken up in 2012 (IADB interview, January 24, 2012). While this may sound promising from the borrower’s point of view, several EDs voiced caution, suggesting that Chile was a special case because many of its systems had already been brought up to OECD level, and it also borrowers very little from the IADB. A European non-borrower AED at the IADB concurred. “There’s a lot of countries that we will not touch, and continue to operate bank procurement policies in those countries. But if Chile is only borrowing US$200 million from the Bank each year, and their system is perfectly good, then it’s a bit silly not to use it” (IADB AED interview, January 31, 2012).

The resistance to greater use of country systems at both the World Bank and IADB has clearly been driven by non-borrowers, most notably the U.S.,[53] with the Europeans and Japan also reluctant. Pressure seems focused mainly on procurement—due to a combination of fears of corruption and self-interest among non-borrower business interests—and environment—due to the political pressure of the environmental lobby (see, for example, Indian Law Resource Center, 2010; Heinrich Böll Stiftung, 2011; and Friends of Earth, 2012). The Swiss ED, discussing the P4R negotiations, said, "The barrage of fire that has come from contractors on one side and the professional NGO bureaucracy on the other side has been amazing" (World Bank ED interview, January 13, 2012).[54] The reality of voting power in both the IADB and World Bank—most particularly the veto power of the U.S. over any capital increase, and its willingness to use that power on issues it views as critical—means that both MDBs are unlikely to make any major moves toward the use of country systems on a broad scale for the foreseeable future.

5.5 Conclusion

The accumulation of evidence reviewed here supports Hypothesis 1, that the non-financial characteristics of each of the three MDBs do clearly vary as a direct function of the balance of power between non-borrowing and borrowing shareholders. Further, preliminary evidence from MDB interviews and documents suggests that these characteristics in turn act as an important determinant of demand for loans by borrowing countries (Hypothesis 2). This causal link will be explored in more detail in the subsequent chapter, through case studies and interviews with government officials responsible for MDB borrowing decisions.

In all three of the characteristics analyzed here—overall loan processing procedures, environmental and social safeguards and procurement rules—the World Bank is

[53] An OECD study on U.S. implementation of the Paris Declaration agenda reveals a similar finding for U.S. bilateral aid by U.S. AID and the U.S. State Department. A field survey of staff officers found that 79% rarely or never used country systems for procurement, while 84% rarely or never used country systems for financial management and accounting (OECD, 2011).

[54] The Swiss ED specified that his views should be taken as personal, and not representing those of his country.

unquestionably the most willing to impose strict rules above and beyond any national procedures, and to enforce those rules in a rigid, legalistic way. The IADB generally follows the lead of the World Bank in the "letter of the law", but offers borrowing countries more flexibility in implementation, with the end result being somewhat faster and more fluid loan approval procedures. The CAF, by contrast, has few layers of bureaucracy and review and essentially no safeguards beyond following national law, meaning its loans are approved much more quickly and with minimal bureaucratic requirements. As a top level IADB policy staffer put it succinctly, "Countries feel that the IADB is more their bank than the World Bank. But of course they perceive the CAF as even more their bank then the IADB. We are in the middle between the two in these different governance dimensions" (IADB interview, January 18, 2012).

Interviews with country shareholder representatives and MDB staffers, as well as speeches during annual meetings and available MDB reports, all point to the balance of power between non-borrowing and borrowing shareholders as the key variable defining this continuum. The dominance of non-borrower countries in the governance of the World Bank means that their priorities—environmental and social protection (driven by NGO lobbying), procurement rules (driven by a combination of corporate interests and mistrust of borrower government institutions), and multiple layers of internal review (driven by a "principal's" desire to exert strong control over the MDB staff "agent")—take precedence over the desire of borrowers to get loans cheaply and with minimum hassle.

The fact that the IADB is more evenly divided between borrowers and non-borrowers translates into different characteristics. The slight majority of borrowers relating to day-to-day decision-making such as loan approval, coupled with the "trump card" of U.S. veto power over any changes to the capital structure, means borrowers and non-borrowers tend to seek consensus and avoid open conflict on most issues, according to both borrower and non-borrower shareholders interviewed for this research. The main exception is the US's threat of withholding a capital increase if it does not get its way on policy issues it considers critical, for example environmental safeguards or procurement procedures. But even here, the fewer layers of staff oversight and majority vote on loan approvals means that borrowers can influence the way those policies are implemented in a way more amenable to their interests.

In the CAF, by contrast, the shareholding dominance of borrowing countries has led to a very different set of operational characteristics. With the “principals” unified in their goals for the MDB, the “agent” has considerably less incentive to develop or pursue interests that do not coincide with those shareholder goals. Hence the administration is much more vertical with far fewer bureaucratic layers, and management is given much greater freedom and trust by the shareholders. As well, borrowing shareholders have no incentive to impose any extra rules or procedures that go beyond their own national laws, such as the environmental, social and financial safeguards at the other two MDBs. A high-level CAF executive summed the situation up neatly: “Here there’s no difference between donor and creditor countries that causes problems and slows things down in the other banks” (CAF interview, August 24, 2011).

Evidence also strongly supports the idea that the three characteristics analyzed in this chapter have an important impact on the demand for countries to borrow money from one or another MDB, when they are in a position to choose. The rapidity and low hassle factor of the CAF appears to act at least in part to offset the higher interest rate on its loans, particularly in relation to major infrastructure projects where environmental, social and financial safeguards would be more problematic at the IADB and World Bank. The IADB in some ways appears to have the best of both worlds, with financial terms similar to the World Bank by virtue of the economic might of its non-borrowing members, but slightly less onerous non-financial characteristics due to the stronger influence of borrowers. The World Bank, by contrast, appears to be relying on low price and some expertise advantage to attract borrowers, attributes that appear to be declining in importance. Well aware of this fact, World Bank management has made numerous initiatives over the years to reduce the “hassle factors”, but non-borrower shareholders have thus far stymied most efforts. The case studies in the following chapter pursue the implications of MDB characteristics for borrower country demand in more detail.

6 CASE STUDIES OF BORROWER DEMAND: COLOMBIA AND ECUADOR

This chapter comprises two case studies of countries—Colombia and Ecuador—that have dealings with all three of the multilateral development banks (MDBs) under analysis. The previous two chapters investigated how the balance of shareholder power between borrowing and non-borrowing countries in the World Bank, IADB and CAF shaped financial and non-financial aspects of lending activity, which could in turn have an important impact on the demand for MDB loans from the perspective of borrowers. This chapter turns to the views of the countries themselves, to see what criteria governments may have to borrow or not borrow from a given MDB, depending on their own circumstances. The intention is to ascertain if MDB policies and procedures—and hence the shareholder interests that shape them—do indeed play a role in affecting demand for MDB loans (Hypothesis 2).

As well, the chapter provides deeper insight into the particular circumstances of individual countries, and how political economy considerations specific to the realities of a given country at a given juncture in its development might impact borrowing decisions. The overarching hypotheses for this study posit several structural characteristics of MDBs that impact the demand for their loans in systematic ways. The statistical patterns examined in Chapter 3 provided some substantiation for that, however those patterns were not conclusive or as strong as might have been expected if the hypotheses were absolutely valid. This is no surprise. The diversity of political and economic systems in individual countries, the position of those countries in the world economy and the idiosyncrasies of key officials in government and MDBs—and their relations with one another—are far too complex to model in a statistical regression with any degree of exactitude. Considering individual country case studies can help better explain why a country might in some cases not follow the more structural patterns expected by the hypotheses, due to assumptions about variables that do not apply in a specific country or time period, or due to variables not included in the statistical tests.

Lastly, the chapter generates evidence in relation to Hypothesis 3, on the impact of financial considerations on MDB behavior. As discussed in the introduction, the two main resources needed by MDBs are access to resources for the lending (analyzed in Chapter 2) and a portfolio of interest-generating loans to cover MDB overhead costs. When faced with a situation of fluctuating demand for their loans, the hypothesis would then expect MDBs to undertake action to stimulate demand, rather than sit back passively as their loan portfolio diminishes. This chapter finds strong evidence for this, with all MDBs engaging in competitive behavior—something that they publicly deny occurs, preferring the rhetoric of aid coordination and harmonization—in an effort to maintain borrowing clients. Offering budget support loans disguised as investment loans, using technical assistance as a marketing tool to initiate loans and easing off on policy conditionality are among the MDB strategies noted by borrower government officials.

The case studies were chosen based on a number of criteria. First, and most obviously, they had to be among the countries that have borrowed from all three MDBs over a reasonable length of time. Because of the CAF's more limited membership (until very recently), this brought the number of possible options down to five—Bolivia, Colombia, Ecuador, Peru and Venezuela. Colombia was chosen as an upper-middle income developing country, currently with very good access to both domestic and international capital markets and hence with many options for external financing, but with a period of greater economic difficulty in previous years. Peru could have provided an equally interesting case with many similar characteristics to Colombia, but the latter was selected as it is a larger overall economy and has a higher GDP per capita, thus making it a better example of a middle-income country with increasing economic strength and options. Venezuela is also an upper-middle income country with relatively good capital market access, but was excluded because it has had no relations at all with the World Bank since the early 2000s, and the country office is closed.

Ecuador was chosen as an example of a much smaller economy, with considerably less access to private capital markets than Colombia due to macroeconomic volatility and a history of debt defaults. As well, the tense relationship between the current administration of left-leaning President Rafael Correa and the U.S. stand in stark contrast to the close relationship of Colombia to the U.S., which could provide some traction to consider the much-hypothesized link between U.S. geopolitical interest and MDB lending (see for example Harrigan et al., 2006; Dreher et al., 2009a; and Kilby, 2006 and 2011, all of which link lending decisions by MDBs to a country's relative closeness to the U.S.). Bolivia could have also served this role, but was not selected because it has borrowed mainly from the highly concessional lending window of both the IADB and World Bank, meaning the demand dynamics would likely be much different than countries borrowing from the market-based lending window.[55]

The two main sections of the chapter each address the case of an individual country—first Colombia, and then Ecuador. The case studies are based primarily on qualitative evidence derived from in-depth interviews conducted with current and former government officials in each country, who are/were responsible for multilateral borrowing decisions. Generally this involved top-level officials in Colombia's *Ministerio de Hacienda y Crédito Público* (MHCP) and Ecuador's *Ministerio de Finanzas* (MEF), including ministers, vice-ministers and directors of external credit. Officials in Colombia's National Planning Ministry (DNP) were also interviewed, due to the uniquely important role played by that ministry in Colombia's borrowing decisions, while in Ecuador a top official in the Economic Policy Coordinating Ministry—which performs a similar role to the DNP among a sub-set of economic ministries—was also interviewed. The case studies also consider data on the lending portfolio of each country from each of the three MDBs. The chapter concludes with a section drawing lessons from the two case studies for the broader research project.

[55] Because World Bank IDA and IADB FSO loans are highly concessional (50 year repayment terms and minimal or no interest rate), the demand for those loans would naturally be much higher than for market-based lending.

6.1 Colombia: A Sophisticated Middle-Income Borrower with a Long-Term View

As a major middle-income country in Latin America, with a growing economy and a stable macro-policy stance over the medium term, Colombia serves as a good example of the kind of country that has an increasing number of options when considering how to best fill its sovereign financing needs. With relatively low debt, sustainable fiscal balances and good access to capital markets, the country is not in a position of high dependence on multilateral lending, and thus demand-side factors are clearly very important in shaping the country's interactions with the three MDBs. In short, Colombia is now an MDB client by choice, not by necessity.

The evidence presented below substantiates that the factors analyzed in the previous two chapters are indeed important for Colombia, but interviews point to a more nuanced prioritization in the view of government officials. Loan pricing and the ability of MDBs to offer knowledge services in specific areas of interest to the government are critical; loan processing speed, safeguards and the behavior of MDB staff are relevant but less important; and procurement hassles are a relatively minor concern. As a result, the World Bank and the IADB are more favored by Colombia, while the CAF is lowest on the list, though with certain advantages of its own to bring to bear. All three MDBs make considerable efforts to "compete" with one another and private markets to maintain their relations with Colombia, including developing new financial products, targeting specific niches, leveraging technical assistance to make loans and easing off on policy conditionality, among other strategies.

Colombia is Latin America's fifth-largest economy (after Brazil, Mexico, Venezuela and Argentina) as measured by GDP in 2010, and has a GDP per capita of US$6,225, placing in the "upper-middle income" bracket according to the World Bank (2012e). Despite its international notoriety for cocaine production and guerrilla violence, Colombia has had a relatively stable democratic system with regular elections and peaceful political transitions. Its civil service is highly respected in the region as capable, reform-oriented and with a long-term planning horizon somewhat distanced from political considerations.

Although it is difficult to measure quantitatively, some indicators do support this assertion. The World Governance Indicators for 2010 ranked Colombia as sixth out of 20 major Latin American economies and in the 61st percentile for the government effectiveness indicator (compared to 15th for Ecuador, in the 29th percentile), and seventh in regulatory quality in the 60th percentile (compared to 18th place for Ecuador in the 11th percentile) (Kaufmann et al., 2010). Similarly, a "Weberian" index measuring the degree to which public sector bureaucracies employ meritocratic recruitment and predictable, long-term careers ranked Colombia 11th out of 35 developing countries (compared to 28th for Ecuador, with a score half that of Colombia's) (Evans and Rauch, 1999).

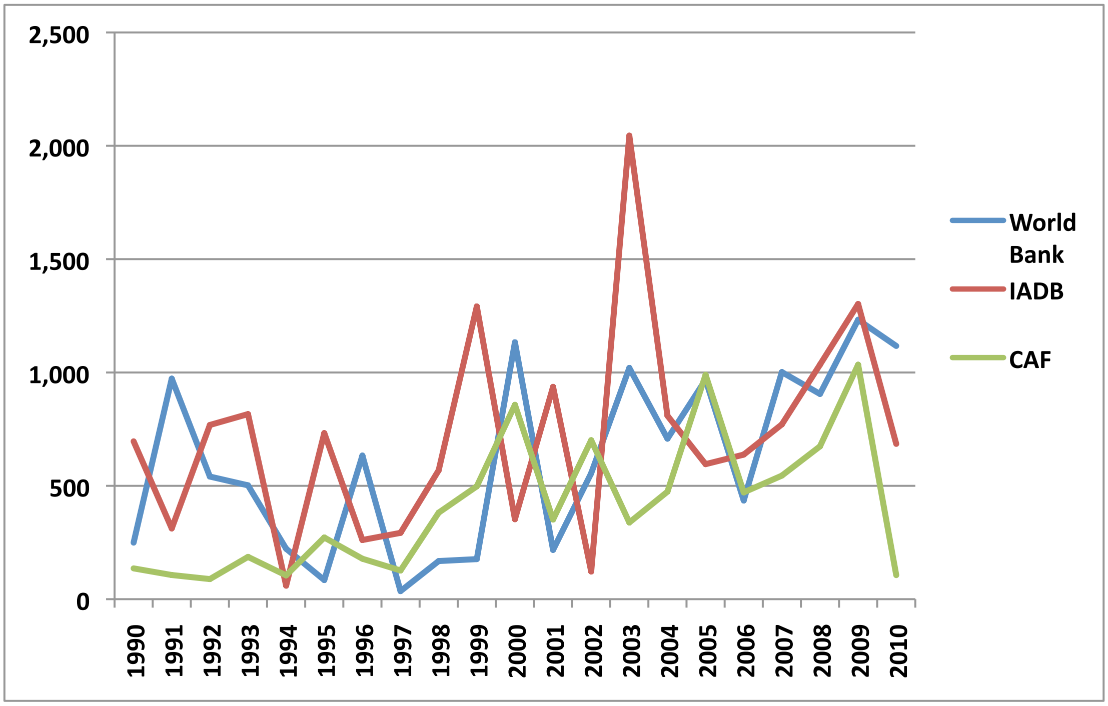
Colombia has experienced less macroeconomic volatility than many of its neighbors, largely avoiding the debt crisis of the 1980s and facing an important (though not catastrophic) downturn only during 1998-2002.[56] Colombia began issuing bonds in international capital markets in 1993 (when it was first granted a rating by Moody's and other ratings agencies), and was elevated to "investment grade" status by both Moody's and Standard and Poor's in the spring of 2011 (Bloomberg, 2011). International reserves stood at US$24 billion in 2009, a solid 10% of GDP, and growth average 4.7% of GDP between 2004 and 2010 (World Bank, 2012b). Hence, the country embodies the trends among many developing countries that this thesis seeks to understand—dynamic economic growth, stable public finances and solid access to international private capital markets on good terms.

Trends in lending commitments to Colombia by the three MDBs since 1990 reveal a number of patterns worth noting, to be explored in more detail below. First, the CAF has clearly lent the least of the three MDBs to Colombia for the entire period, although its lending has generally risen in absolute terms (Figure 6.1). Second, no clear pattern is apparent differentiating lending by the World Bank and IADB, apart from a slight tendency to borrow more from the latter (especially in the late 1990s and in 2003). Both of these patterns go against the predicted outcomes derived from the hypotheses tested in

[56] GDP growth slowed to 0.5% in 1998, fell by 4% in 1999, and recovered gradually thereafter (World Bank, 2012b).

Chapter 3. The question to be addressed below is whether the causal factors from which the hypotheses were derived are not relevant in Colombia, or whether other factors not taken into account in the hypotheses are more important in this country case.

Figure 6.1. Annual MDB Lending Commitments to Colombia, 1990-2010 (Real 2010 US$ millions)



Source: World Bank AR, IADB AR, CAF AR, 1990-2010.

To answer this question, 10 high-level Colombian officials were interviewed as part of this research project, all of whom have or had significant dealings with all three MDBs and decision-making authority on MDB borrowing. Interviewees worked either for the MHCP, DNP or sectoral ministries (see reference section for complete list).[57] Officials pointed to a number of factors specific to Colombia—but with broader application—that led to MDB borrowing patterns somewhat different than those predicted by the hypotheses in Chapter 3.

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[57] In Colombia's executive branch, the DNP is a "super ministry" overseeing and coordinating the government's activities among the different line ministries, while the MHCP is in charge of issues related to public finances. The two coordinate closely on decisions related to external financing (including MDBs).

6.1.1 Price and Technical Assistance are Paramount

According to top officials currently or recently in charge of contracting debt from multilateral sources at the MHCP and DNP, the two main criteria in deciding whether to borrow from an MDB, and which one, are cost (the interest rate on the loan) and the value of technical assistance the MDB can provide the Colombian government for its priority projects. Perhaps unsurprisingly, the emphasis of MHCP officials was on the cost factor as the first "filter" while DNP officials stressed the importance of technical value-added as primary, but both agreed that the two were by far the most relevant criteria, especially in situations like the present when Colombia is not facing urgent need for financing and can take opt to take loans only when it suits the country's needs. As a recently retired vice-director of DNP put it, "Price is important, but it's not just a case of financing. In terms of supply of funds we have no problem at all at this moment. So the question is what is the value-added that we can have as a country with this multilateral compared to another, and how can we guarantee that" (Ramírez, May 30, 2012).

In terms of cost, all officials interviewed stated that both the World Bank and IADB were extremely attractive sources of finance. The current MHCP public credit director stated that the World Bank and IADB offer loans at very similar rates, and are both invariably lower than any other source of sovereign financing. The official added that IADB loans are frequently slightly cheaper than the World Bank's, a finding that coincides with the research in Chapter 4 (Gómez, May 29, 2012). The CAF, on the other hand, is considerably more expensive, currently even more expensive than Colombia's own sovereign bonds, according to the MHCP's sub-director of multilaterals from 2009 to 2012 and now a top advisor. "The CAF has made a big effort to reduce its margins in recent years, but they can never compete with the World Bank and IADB because of the shareholder composition of the bank. They have a much lower rating because the owners of the bank are another category of country. It's a structural issue" (Rojas, May 29, 2012), again echoing the findings of Chapter 4. MHCP and DNP officials noted that the CAF's loans had formerly been much more attractive in terms of pricing, but Colombia's own borrowing costs had dropped more quickly in the past 10 years, even though

Colombia sovereign debt is still rated below CAF bonds by the top three rating agencies.[58]

The comparison of technical assistance provision by the MDBs again provided a similar result, with the World Bank and IADB roughly equal. The DNP official in charge of multilateral credit said that the level of technical assistance was not significantly different between the two larger MDBs, largely because the IADB improved dramatically in recent years in response to demands from borrowing countries (Bargans, June 6, 2012). A former DNP vice-director concurred, saying the IADB operated in some sectors in Colombia and the World Bank in others not because of any over-riding superiority in a given topic, but because of the familiarity of MDB and government staff and past experiences. “It’s a bit like a path dependence process,” he said (Ramirez, May 30, 2012).

The World Bank, in particular, appears to have been quick to come to terms with the new focus of the Colombian government on technical assistance provision, and according to officials is using that as an incentive to market its loans. A second former DNP vice-director described a 2002 presentation of a collection of World Bank policy notes (World Bank, 2003a) covering the country’s development agenda over the course of an entire weekend with the new Uribe cabinet. “It was a marketing technique, it really help set up the World Bank for a lot of lending. The IADB could not put out a book that comprehensive” (Gaviria, June 6, 2012). Similarly, a former MHCP vice-minister, who also served briefly as a top official in the Transport Ministry, said that in 2011 she was seeking assistance on addressing some of the country’s infrastructure deficits. “I spoke with people of the World Bank, and they said, ‘Sure we can help, but take out a loan with it too.’ They were very helpful, but had expectations. It was like a marketing tool” (Agudelo, June 7, 2012).

[58] CAF loans are at times more expensive than Colombia’s sovereign bonds, despite its own higher bond rating, for two reasons. First, bond ratings do not translate directly into pricing, but rather merely offer a guide by ratings agencies that investors can interpret as they see fit. Second, CAF’s bonds may be cheaper than Colombia’s, but it must charge borrower clients a margin above its own cost of funding on loans, to pay for administrative overhead. This margin may be enough to push its loan costs above Colombia’s bond yields.

As with the price criteria, the CAF is a distant third place to both the IADB and World Bank for technical assistance provision, from the point of view of the Colombian government. Along with every other official interviewed, the DNP multilateral credit director said that the CAF simply did not offer any meaningful technical assistance, and that Colombia did not take that into account when considering a CAF loan (Bargans, June 6, 2012). The CAF is able to occasionally bring in experts on a given theme—particularly infrastructure, a focus of CAF lending—but that this was of limited value to the government. The director of multilateral assistance at the Environment Ministry agreed that the CAF was unable to provide technical assistance. "They show up and say, 'this is what we can lend,' and that's it. They don't offer anything along with it, which to me makes them less attractive" as a source of loans (Bautista, June 1, 2012).

6.1.2 Diversification, Ownership Structure, Reduced Hassles

In light of the above findings about the CAF—that its loans are more expensive than Colombia can issue bonds on the private markets, and that it offers essentially no technical value-added—one then logically wonders why the Colombian government takes any loans at all from the CAF. Officials explained their continued use of the CAF for three reasons. The first is Colombia's long-term strategy of maintaining good relations with all MDBs (as well as other sources of funding), to have access to capital should the government find itself in need. "We have an unwritten policy not to lose our niches," according to a top DNP official. "When all goes well we have access to resources, but when the markets close, we have to open doors, so we can't turn our backs on the CAF knowing that when we need them they can throw us a lifeline" (Bargans, June 6, 2012). A former MHCP minister agreed that Colombia consciously maintained its portfolio with the CAF to ensure good relations in the event of a crisis. "Colombia has always maintained a relationship [with the CAF]. There's a certain margin of difference that we accept paying.... This diversification is a good strategy for the country to maintain its sources of financing" (Zuluaga, May 30, 2012).

The second reason relates more directly to the shareholding characteristics of the CAF compared to the other two MDBs. Because of the fact that the CAF is owned by a small number of borrowing country shareholders, of which Colombia is one, the country feels a proprietary interest—or even a certain obligation—that drives it to borrow from the CAF, despite the higher cost and lack of technical expertise. A former MHCP vice-minister said that during her time in the ministry (1999-2006) there was political pressure to give business to the CAF even if they were more expensive, because the country was a part owner. The official recounted a story of when some people in the ministry wanted to pre-pay a CAF loan because it was expensive, but were blocked from doing so because of political pressure. "There are considerations that go beyond just the finances," the official said. "The finance minister, the head of the central bank, they sit on the board of the CAF so they feel they are owners, so they don't treat it like the World Bank or the IADB" (Agudelo, June 7, 2012). The DNP multilateral director said the CAF use this to convince Colombia to take sovereign loans, pointing out to government officials that it needed loans on its books from highly-rated countries like Colombia to solidify the CAF's own credit rating, which would in turn bring down the cost of future loans to Colombia (Bargans, June 6, 2012).

The third factor influencing greater borrowing from the CAF than might otherwise be the case relates to the analysis of Chapter 5—greater speed and fewer bureaucratic hassles in loan processing. Officials noted that this was not in and of itself a major factor, because Colombia tends to have a long planning horizon, but did prove useful in marginal cases when the government needed to receive resources or start a project more quickly. A former MHCP minister directly linked the CAF's flexibility and speed to the shareholding composition, as found in Chapter 5: "It's much easier and faster for a country to get a loan from the CAF than the other banks, their requirements are much more complex and extensive, there's more conditions, because most of the guarantee capital is from the richer countries. In contrast, with the CAF no one outside is involved, it's just the countries of the region, there's no European or North American capital involved. This gives a lot more flexibility" (Zuluaga, May 30, 2012).

A former MHCP vice-minister spelled out the process with the CAF as follows: "A minister calls [CAF President] Enrique García and says 'we need 200 million,' and he says to his team, 'go to Bogotá and set this up.' They say to us, 'go ahead and design the loan yourself.' There's not this horrible negotiations like there are with World Bank and IADB, which send very technical people who have their own ideas. Not the CAF. The others are less expensive, but the CAF disburses everything within six months. So I might go with the CAF" (Agudelo, June 7, 2012). Several DNP and MHCP officials said that this process advantage would lead the government to borrower even more from the CAF in situations where the government needs pure financing without technical assistance, if the CAF were able to lower loan rates and lengthen maturities.

Comparing the World Bank and IADB on speed and hassle factor, officials offered mixed responses about which MDB is easier to work with. All agreed that both MDBs had improved notably in recent years, bringing down approval times to under a year in both cases. A more decentralized and horizontal organizational structure pointed to a marginal advantage for the IADB, albeit one that did not appear determinative in making loan decisions. Several sources noted that the local office of the IADB had a greater number of sectoral specialists as well as greater autonomy in making loan decisions compared to the World Bank. For example, the fact that the World Bank's country director is based in Mexico City was seen as problematic by several officials for making quick decisions and resolving problems. Officials also complained that loan preparation with the World Bank tend to be more complicated, because of multiple layers of approval above the project team itself. "All these committees at the World Bank are nightmare," commented a former MHCP vice-minister. "The technical team might reach an agreement, but the committees in Washington become a burden. We're sitting here negotiating, but the person I'm negotiating with doesn't have the power. Above them they have five bosses and all these committees. So who am I negotiating with?" (Agudelo, June 7, 2012). According to the top DNP official for multilaterals, loan negotiations (the final phase before seeking board approval) can take up to three days with the World Bank, but rarely last more than half a day with the IADB. CAF negotiations are even faster, usually involving a short telephone call rather than a face-to-face meeting (Bargans, June 6, 2012).

Chapter 5 also emphasized differences in environmental, social and procurement safeguards as a major advantage for the CAF, because it simply uses country rules and does not impose any external procedures on a borrower, unlike the IADB and (to a slightly greater extent) the World Bank. Officials agreed with the chapter's characterization of the degree of strictness of each MDB's safeguards, with the World Bank as the strictest, the IADB a close second and the CAF without any significant safeguards at all. For environmental and social issues, several officials reported that safeguards were indeed problematic, and that they increasingly preferred to avoid the World Bank and IADB as a result. One MHCP official recounted that IADB social safeguards resulted in a highway project in Pasto ending up "taking three years and costing five times more than any highway in Colombia's history," which she said was leading ministries to consider using the CAF or other sources of finance for environmentally problematic projects (Rojas, May 29, 2012).

The Environment Ministry staffer in charge of multilateral projects recounted similar stories involving resettlement and indigenous safeguards with both the IADB and World Bank, including one rural development project that the government entirely redesigned to avoid having the loan impact any indigenous areas, specifically to not trigger World Bank safeguards. "The [World Bank] project team understood us, but the safeguard people were very radical in their position," she said. "We couldn't let these safeguards be triggered, or we'd have to do everything that the World Bank wants us to do. We can't have to do 50 consultations and make sure everyone's happy every time we do anything." The official also noted that, as found in Chapter 5, the safeguards of the IADB had formerly been considerably more relaxed than the World Bank, but had tightened up considerably in recent years (Bautista, June 1, 2012).

Procurement safeguards, unexpectedly, seem to work in favor of the IADB and World Bank and against the CAF in the case of Colombia. This is due to the well-developed system of governmental checks and oversight in Colombia, and in particular the extraordinarily complex procurement legislation known as Ley 80 (Congreso de Colombia, 1993). Several officials expressed annoyance that the World Bank and IADB insisted on their own rules for procurement, and uniformly disparaged the efforts of the IADB's country systems approach and the new P4R lending instrument at the World Bank as "anachronistic", in the words of a top MHCP official (Rojas, May 29, 2012). They also voiced appreciation that the CAF relied exclusively on country systems. However, in practice, they all noted that using World Bank and IADB systems was in fact considerably more efficient in terms of contracting and procuring than following their own legislation. Both DNP and line ministry officials commented that project leaders sometimes actively sought out financing from the IADB and World Bank simply to bypass the overly complicated procedures required by Ley 80 (Bautista, June 1, 2012 and Ramírez, May 30, 2012).

6.1.3 Budget Support vs. Investment

Another aspect of MDB lending of considerable importance to Colombia is the amount of resources lent for general use in the budget, as opposed to loans funding a specific, defined project. Logically, Colombia (like almost all MDB borrowers) prefers to receive more non-earmarked resources that they can allocate as they see fit. Both the World Bank and IADB have rules limiting the amount of general budget support loans for each country (50% and 30% of country lending, respectively), which were imposed by non-borrowing shareholders seeking to maintain control of resource use. However, Colombia has in nearly every year since 2000 surpassed those limits for both banks. Several DNP and MHCP officials made it clear that Colombia's ability to surpass budget support limits came from direct pressure from the U.S. within the multilaterals in support of Colombia—providing evidence in support of the frequently posited claim of the U.S. using the multilaterals to further its own geopolitical interest.[59] A former DNP director confirmed that such agreements were made informally, with the strong support of the U.S. government. "When we went to Washington, we always went first to the U.S. Treasury, because they run things at the World Bank," he said. "So we always went there first. And the White House would say, 'we have to help Colombia.' And the IADB too, it

[59] Colombia has long been a close regional ally of the U.S., with strong support by the U.S. for Colombia's fight against narcotics production/trafficking and the conflict with leftist guerrillas. The conservative administrations of President Bush (2000-2008) and President Uribe (2002-2010), with strong emphasis on drug interdiction and a hard line against the guerrillas, were particularly close.

was the same thing. The principal shareholder is the U.S. and Colombia has always had a very close relationship with the U.S. And that always helped us a lot to get what we needed from the multilaterals" (Montenegro, June 1, 2012).

Unlike the other two MDBs, the CAF does not explicitly offer budget support loans—in good measure, no doubt, to reassure bond buyers that its loans are for concrete, high-return projects, much as described in Chapter 2 during the early years of the World Bank. However, because of the CAF's flexibility and lack of obsessive control by shareholders over resource use, it is able to offer loans that serve as budget support, which the Colombian government has found useful. The top DNP multilateral official described the process as follows: "For example we needed resources for infrastructure and we added up all we needed and asked the CAF as an amount to finance our budget, but they presented it to their board as a project to support infrastructure. The money is fungible. That's what their budget support loans are—they draw up something that looked like an investment, but for us it's a budget support loan" (Bargans, June 6, 2012). MHCP officials pointed to a number of fast-disbursing infrastructure projects in recent years by the CAF as functioning essentially like budget support.

Government officials praised all three MDBs equally for being quick to facilitate large loans to Colombia in times of financial difficulty, notably in the early 2000s (a deep recession caused by several domestic and international factors) and again in 2008-09 (the global credit crunch). During the 2002 start of the Uribe administration private markets were essentially closed to Colombia, and the government took as much loans as it could from all three MDBs, although the preference was for IADB and World Bank loans due to price considerations. As hypothesized in Chapter 3, the CAF faced its own restrictions during the early 2000s because of market risk perceptions about its bonds due to the regional economic turbulence, limiting its usefulness at that time. "With the IADB and the World Bank it always easy to finance, they almost never suffer because of the turbulence in the markets," one former MHCP official said. "They didn't have any problems during our crisis. But the CAF did, and so the amounts [borrowed from the CAF] were very limited at that time" (Agudelo, June 7, 2012). By contrast, the IADB was able to offer a US$1.25 billion emergency loan in 2003 (with the active support of the U.S. government, according to Colombian officials).[60] A similar pattern is apparent during 2008-09, when lending spiked for all three MDBs, but clearly more for the World Bank and IADB compared to the CAF. Thus the hypothesis in Chapter 3 that countries tend to move toward the World Bank and IADB more than the CAF during a crisis seems borne out in the Colombian case, for the reasons posited.

6.1.4 Competition for a Valued Client

As Colombia has developed in recent years, moving to investment grade status and solidifying its position as one of the strongest middle-income economies in Latin America, the MDBs have had to adapt to the needs of the country to maintain the position as lenders. As the above analysis makes evident, apart from two brief times of crisis Colombia has been in a relatively strong economic position in recent years and has not been shy about making its demands felt. As a former MHCP minister observed, "There's a spirit to put more into the relation to keep a country like Colombia attracted to the banks. No one is interested in losing a client with good risk. The banks are still banks. Colombia's been a very good client to the multilateral banks, and nobody wants to lose a good client" (Zuluaga, May 30, 2012).

One aspect of MDB lending that has changed dramatically in recent years, according to several officials, is the use of policy conditionality on budget support loans with the World Bank and IADB. Throughout the 1980s and up to the early 2000s, Colombia was forced to undertake politically difficult policy changes against its will to secure financing. All officials interviewed who worked in either the MHCP or DNP during the late 1990s and early 2000s complained bitterly about the difficult policies imposed onto the government especially by the World Bank, and to a lesser degree the IADB, in exchange for badly needed resources. For example, referring to a budget loan related to social policy, a former DNP deputy director said, "There was some World Bank bureaucrats

[60] While the large amount was very useful to help the incoming administration solidify its finances, the special emergency loan was also at an unusually high interest rate (6-month LIBOR + 400 basis points, plus 1.75% in fees), and Colombia quickly pre-paid the loan when its international reserves grew in 2005. See Vargas, 2005.

who had some knowledge of social policy who were taking advantage of the needs Colombia had at the time to impose all these different ideas and obsessions. This was less a problem in the IADB, not much less but definitely less at that time" (Gaviria, June 6, 2012).

However, with Colombia's increasing economic strength, the days of the World Bank and IADB imposing policies that the government does not want to do appear to be gone, even during times of need such as in 2008 and 2009. "We have gotten a lot stronger in the last 15 years," according to a top MHCP official. "We don't let them put in anything [the policy loans] that we don't already want to do. We don't let them push us. Fifteen or 20 years ago, they imposed much more, but now we are in a stronger situation with many sources of financing." The official added that reformist bent of many Colombian officials made it easy for the World Bank and IADB to construct policy loans, simply by looking for what reforms the government was already doing and building a loan around it (Rojas, May 29, 2012). The DNP multilateral official told a similar story, saying that policy loans "are now relatively easy for us to prepare, because they are using reforms that are ready, the banks don't oblige or demand anything, practically. We sell what we have done. When I got in here, it wasn't like that. Then they imposed on us. But at a certain point we said 'you either buy our reforms or we're not interested in your loans. We are now a client and you need to attend our needs'" (Bargans, June 6, 2012).

This new, more accommodating spirit on the part of the World Bank and IADB is also apparent in the relationship between project teams and government counter-parts. The Environment Ministry multilateral director said that in her experience, both MDBs make considerable efforts to ensure that the country is happy with the MDB project team. She recounted an episode from the mid-2000s when the task manager of a loan project was causing problems. "The vice-minister called the [World] Bank and said, 'Either you change the task manager or we cancel this project.' And the loan was for US$800 million. The Bank is not going to let that loan fail, so they changed the task manager, because that's their business. Now Colombia can say, 'We won't take that loan,' because the government is in a much stronger position" (Bautista, June 1, 2012).

All three MDBs have made considerable efforts to design new financial instruments beyond bread-and-butter loans to continue providing financing to Colombia. This includes operations in local currency as well as various types of swaps and hedging instruments to help Colombia manage its risks. According to MHCP debt officials, since 2008, first the World Bank and then the IADB began offering a variety of options for swapping disbursements into local currencies linked to inflation, which helps the government better manage financial risks. "The World Bank has made more progress on that front, more than the IADB. The IADB is still catching up," said one official (Gómez, May 29, 2012).

By contrast, the CAF offered minimal financial instrument innovation, a reflection of its more tenuous financial standing and therefore room to manoeuvre in capital markets compared to the two larger MDBs' stronger bases of shareholders. However, the CAF has made the most of the operational versatility afforded to it by its more streamlined shareholder arrangements in providing services not available to the IADB and World Bank. For example, the MHCP uses the CAF as a deposit-taking institution to manage its liquidity issues. This arrangement generates a high interest rate for Colombia from a trusted financial institution that it partly owns, and provides resources to the CAF to on-lend without requiring bond issues, very convenient during times that the CAF might face high bond market interest rates. The CAF is also able to lend directly to sub-national governments in Colombia without a national guarantee, unlike the IADB and World Bank, thus helping finance local government investment without increasing the contingent liabilities of the national government, a valuable service from the point of view of the MHCP (Gómez, May 29, 2012).

6.1.5 Summarizing Findings

The case study of Colombia reveals a number of country-specific characteristics that help explain why the MDB lending patterns illustrated in Figure 6.1 do not fully conform to those predicted by the hypotheses. Borrowing from the CAF has not increased as much as expected in a country with increasing access to finance and generally reduce need, either over the long term or during particular boom years. Nor has IADB lending shown an expected overall increase in the long term relative to the World Bank. During periods of crisis, Colombia has tended to turn equally to the World Bank and IADB, with if anything an emphasis on the latter as opposed to the former.

The reason for the "underperformance" of the CAF seems to be simply that the main characteristics hypothesized as being a major advantage of the CAF—the speed and reduced hassle of loan processing—are less important to Colombian officials than technical expertise and price. While Colombian officials do complain that the World Bank and IADB are slower and more cumbersome (as shown in Chapter 5), this is not a deal-breaker, due to the more long-term planning horizon and professional, reformist inclination of Colombian civil administration. Further, the rigid, time-consuming oversight institutions in the Colombian governmental system—notably procurement and the budget approval process—make the use of national procedures by the CAF much less of an advantage. By contrast, the lack of technical assistance provision and higher cost mean that the CAF is lowest on the list of MDB sources for Colombia, even during a time of crisis. At the same time, these disadvantages of the CAF are mitigated by 1) Colombia' policy of maintaining good relations with all MDBs in case of a crisis; 2) the ability of the CAF to use Colombia's shareholding involvement to arm-twist it to take out more loans; and 3) the CAF's operational flexibility in making sub-national loans and providing de facto budget support through investment operations.

The ability of the World Bank and the IADB to package low-cost loans along with useful technical assistance has helped them both maintain a strong position as a source of development lending to Colombia, outweighing hassle factors that might play a stronger role in other countries. The relatively comparable loan price and the perceived near-equality in technical assistance has led to lending from both MDBs to remain relatively even over time. Further, the ability of both MDBs to supply very high levels of budget support loans—apparently due at least in part to the strong support of the U.S. government—has further heightened their appeal, especially when combined with the willingness of both MDBs to ease off on binding policy conditionality that caused political difficulties in the past. The marginal advantages of the IADB over the World Bank along lines suggested in Chapter 5—closeness to the client, slightly reduced bureaucratic procedures—appears to be offset in Colombia by the ability of the World Bank to bring its highly-valued global expertise to bear and to provide innovative financial products useful to the Colombian government's financial risk management strategies.

6.2 Ecuador: Political Sensitivities and Short-Term Horizons

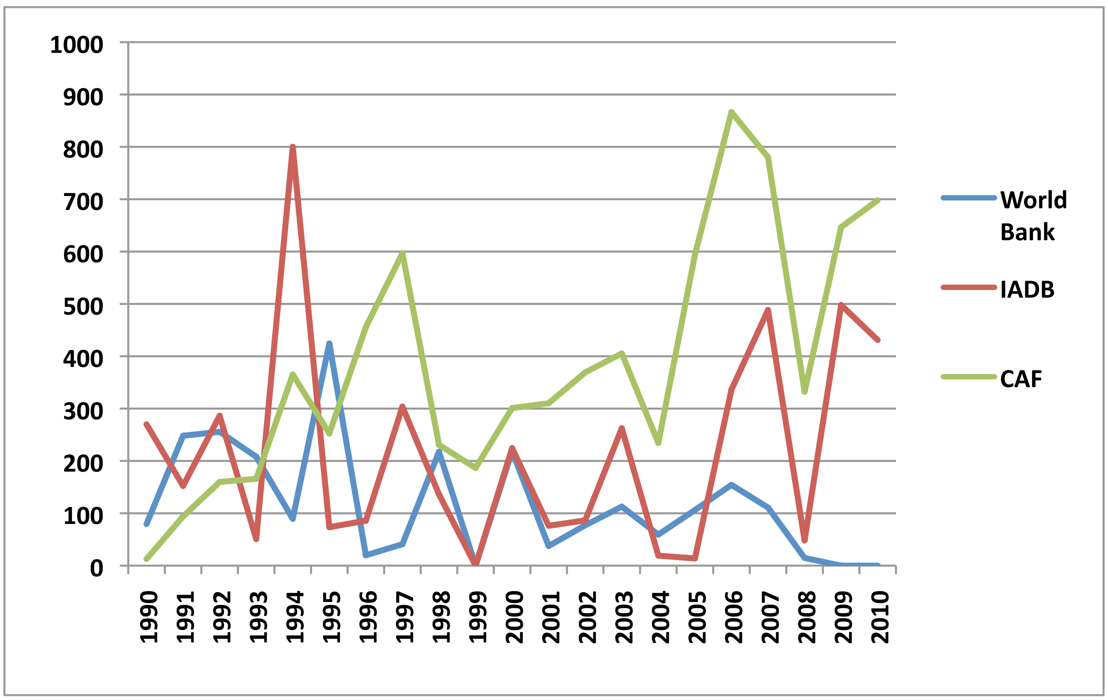
Ecuador presents a contrasting economic and political context compared to Colombia, and its interactions with the three MDBs reveal a very different weighting of the same main factors on the part of government officials. Here again, the demand side appears key, with Ecuador riding an oil boom and having access to alternative sources of sovereign loans, making it much more choosy in its relations with the MDBs, although with a completely different outcome than in Colombia. In a sense, Ecuador is at the opposite extreme from Colombia, at least in recent years—short-term political considerations appear paramount in shaping external borrowing decisions, making speed and lending volume by far the most important considerations in the eyes of the government, far beyond technical assistance provision or even price. At the same time, ideological considerations have played a major role in recent years, to the detriment of World Bank and (partially) IADB lending, and here again the relationship with the U.S. seems to have had an impact. Interestingly, this conflict appears to have had both a demand and supply side effect—reducing Ecuador's willingness to work with the World Bank, and possibly limiting the amount and flexibility of funds made available to the country by the IADB. These events have combined to push lending by the CAF to the upper limit, and also for the Ecuadoran government to recur to huge loans by the Chinese, despite very high interest rates charged.

A defining characteristic of the Ecuadoran economy is a very high level of volatility, driven both by dependence on a few commodities (mainly oil) that fluctuate widely on international markets and by frequent, dramatic changes macroeconomic policies. Ecuador's average growth rate between 1982 and 2010 was 2.8% (World Bank 2012b), lower than the 3.5% registered by Colombia, but volatility has been very high. Ecuador faced three years of economic contraction in the 1980s, and a huge fall of over 6 percent of GDP in 1999 during the crisis that led to dollarization. Growth has been relatively strong in the 2000s, due in large part to high oil prices, but international reserves were only US$2.6 billion in 2010, down from US$4.3 billion in 2008 (Ibid.). Ecuador was first assigned a credit rating by Moody's in 1997, but was downgraded steadily until the late 2000s and remains well below investment grade. Since a partial default on its sovereign bonds in 2008, Ecuador has remained entirely shut out of international capital markets.

This economic volatility has gone hand-in-hand with an equally unstable political panorama. Three presidents have been overthrown by various means since 1997, and the country has been governed under three constitutions during the same time period. The political party system is unstable, and the civil service is highly politicized. The World Governance Indicators for 2010 ranked Ecuador 15th out of 20 major Latin American economies and in the 29th percentile for the government effectiveness indicator, and 18th in regulatory quality in the 11th percentile (Kaufmann et al., 2010). An index measuring the degree to which public sector bureaucracies employ meritocratic recruitment and predictable, long-term careers ranked Ecuador 28th out of 35 developing countries with a score of 4.0, compared to Colombia's score of 8.5 and 11th place ranking (Evans and Rauch, 1999). As one example of the impact this has had on macroeconomic policy continuity, Ecuador has had 27 ministers of finance since 1991 (compared to nine for Colombia), with only one lasting more than two years (current Finance Minister Patricio Rivera, who took office in April 2010) and five in office for less than five months (MEF, 2012a).

The lending commitments of the three MDBs to Ecuador since 1990 stand in stark contrast to those of Colombia (Figure 6.2). The rise of CAF lending starting in the mid-1990s is remarkably steep, with the smallest MDB lending significantly more to Ecuador each year from 1996 to the present. Lending by the IADB is clearly second, although with great volatility, while World Bank commitments are also volatile for most of the 1990s before dwindling to nothing by the end of the 2000s. The long-term patterns do fit the overall prediction of the hypotheses—with CAF lending increasing relatively most, the IADB next and the World Bank last—and the results of boom years also could conform to expectations. Whether the causal factors behind these trends fits the hypotheses remains to be seen. And MDB lending during a crisis clearly does not fit the expected pattern, with the CAF being the MDB of choice during the 1999-2000 crisis and the 2009 global financial crisis. Both World Bank and IADB lending did spike in 1999, but less than the CAF, while World Bank lending was at zero during 2009.

Figure 6.2. Annual MDB Lending Commitments to Ecuador, 1990-2010 (Real 2010 US$ millions)



Source: World Bank AR, IADB AR, CAR AR, 1990-2010.

To understand the factors behind these lending patterns, eight current and former officials responsible for multilateral borrowing decisions in Ecuador in recent years were interviewed.[61] This included three former ministers of finance, the current vice-minister of finance, and the top two officials in the MEF's office for multilateral credit. As well, the current vice-minister of the Ministry of Economic Policy Coordination (MCPE) and

[61] See reference section for a complete list.

his top assistant were also interviewed. The MCPE plays a similar role in Ecuador to the DNP in Colombia, undertaking a more strategic overview of economic policy, while the MEF is directly in charge of the country's finances.

6.2.1 The Role of Ideology in Ecuador's Multilateral Borrowing

The complete disappearance of World Bank lending to Ecuador following 2008 is relatively easily explained: on April 25, 2007 recently elected President Rafael Correa declared the World Bank representative Eduardo Somensatto "persona non grata," expelling him from the country (Behar, 2007), and since that time the country has not take out a single loan from the World Bank. While the World Bank's loan portfolio to Ecuador has been relatively modest for a number of years, due to country exposure limits, the decline of World Bank lending left a financing gap that has, at least in part, been filled by the other two MDBs, as well as bilateral sources as discussed below.

The current conflict between Ecuador and the World Bank has its roots in a much greater willingness on the part of World Bank officials in past years to require very strong actions by Ecuador in return for loans, especially in the context of policy-based budget support lending—much stronger than the requirements faced by Colombia. For example, a 2000 budget support loan for US$150 million required fully 50 separate policy conditions, including the passage of at least seven laws by Congress (a sovereign branch of government over which the executive nominally has no authority, even though the executive negotiated and signed the loan agreement), covering a huge array of issues including wholesale revamping of the tax code, creation of an oil revenue savings fund, privatization of the telecommunications and electricity sectors, the intervention and closure of 14 private banks, abolition of universal deposit insurance, and various internal fiscal controls and audit provisions, among others (World Bank, 2003b). This is a truly astounding set of commitments, especially in 2000 (as opposed to the heavy-handed years of the 1980s debt crisis structural adjustment programs) and for a relatively small amount of money. By contrast, a US$400 million budget support loan to Colombia approved in 2001 contained conditions in only nine policy areas, and all that related to legal provisions were worded carefully to not make any conditions on the actions of the legislative branch (for example, only requiring that the executive submit a legal reform) (World Bank, 2001e).

This very heavy-handed attitude of the World Bank toward Ecuador is not unrelated to the fact that Ecuador's policy framework was considerably less well-developed and stable than Colombia's. However, from the point of view of Ecuador, it seemed that the World Bank simply pushed Ecuador around because it could, and the country's officials understandably view the institution with considerably more resentment than those in Colombia. A finance minister under President Gutierrez during 2003 and 2004, attributed Gutierrez' overthrow in part to the World Bank's policy demands. "They were very inopportune with a lot of their demands, especially requiring passage of laws in Congress…We agreed with many things in the [policy] matrices, but they also wanted to include things that couldn't be done at that time...We had a minority in Congress, we triggered bigger political problems than we already had...Gutierrez fell because the Congress wanted him out, this was part of the reason he was overthrown" (Pozo, June 12, 2012). The current MEF vice-minister and a high-ranking MEF staffer in the early 2000s also highlighted the World Bank's demands for legal changes as unjust. "As executive, we could propose the law, but we couldn't ensure that what would happen in a political entity," she said. "We said this [to the World Bank], but it didn't matter. They came with their own rules, and that's how it is" (June 12, 2012).

Current President Correa got a taste of the World Bank's attitude during his brief stint as finance minister (April-August 2005). During his time in office, Ecuador's Congress reformed a law governing the oil revenue savings fund, which was created as part of a World Bank budget support loan. The legal changes gave the Ecuadoran government greater flexibility in using oil revenues, which under the World Bank's policy conditions called for paying off public debt (70% of oil revenues) and savings (20%), with only 10% for social spending. As a result of the changes, the World Bank cancelled a US$100 million adjustment operation (World Bank, 2006c). Correa visited the World Bank office in 2005, and had a number of heated exchanges with the country management team and the World Bank Latin America vice-president's team, accusing the World Bank of blackmail and violation of sovereignty.[62] When he returned as president in early 2007, Correa soon cut off relations with the IMF and World Bank. Correa's antipathy to the World Bank has since continued unabated, with him angrily interrupting a speech by then-World Bank Latin America Vice-President Pamela Cox at an Ibero-American summit in October 2011, saying, "Why do I have to listen to lectures from the World Bank vice president, who openly blackmailed my country?" before walking out of the meeting (Agence France-Press, 2011).

Ecuador would seem to be a clear case of a country choosing not to work with the World Bank because of political and ideological reasons. It also exemplifies the need to move beyond aggregate statistical analyses in understanding these issues: a regression analysis of the sort employed by Dreher et al. (2009a), linking voting patterns in the UN with the U.S. position to World Bank lending, would fit Ecuador perfectly, except that the causality is exactly the reverse of the assumed—the decision to not engage was Ecuador's, not the World Bank's or the U.S.'s. According to World Bank staff working on Ecuador as well as MEF officials, the World Bank has repeatedly attempted to launch discussions on new loan projects since 2007, but as yet the Ecuadoran government has refused (World Bank interview, May 14, 2012). The MEF vice-minister said that some conversations have occurred, but that Ecuador was not yet ready to restart a lending relationship (Almeida, June 12, 2012).

The ideological position of the Correa administration has impacted not only World Bank lending, but also that of the IADB. The IADB's reaction may be a case of the U.S. exerting behind-the-scenes influence on the IADB. Ecuador last completed an Article IV consultation with the IMF at the start of 2008 (IMF, 2008), and has since taken the decision not to allow any IMF mission teams in the country, according to both MEF and MCPE officials. The IADB, in turn, has used this as a reason to withhold any budget-support lending to Ecuador (León, June 11, 2012). According to interviews with IADB officials conducted for the previous chapter, an Article IV is not strictly obligatory, and in

[62] Personal experience as a consultant employed by the Ecuador country management team during 2002-2007.

fact a type of "comfort letter" from the IMF would be sufficient (IADB interviews, January 18 and 24, 2012). The MEF vice-minister Almeida—who had in the past worked with the IADB herself—was aware of the exact rule, and pointed to the influence of the U.S. in preventing budget support lending to Ecuador. "In the IADB you have shareholders like the U.S. and Canada who have been very heavy in the discussion and they obviously say this [IMF Article IV] is not negotiable" (Almeida, June 12, 2012). Hence, the U.S.—possibly with the support of other nations—is using its influence at the IADB to restrict budget-support lending to the Correa administration, beyond the letter of the IADB's actual law.

6.2.2 Government Need and Alternative Supply Sources

Ecuador's conflict with the World Bank is all the more surprising in light of the fact that the country has been essentially shut out of international capital markets since December 2008, when it engaged in a selective default of sovereign bonds, followed by a repurchase at a steep discount (Salmon, 2009). The country's sovereign debt is currently rated as the lowest of any country in Latin America receiving a rating from all three major agencies (Guardian, 2012), and its Institutional Investor risk ranking was 28.2 in 2011, also by far the lowest of any ranked country in Latin America (World Bank, 2012f). In part this rather sanguine attitude toward what is—along with the IADB—the cheapest source of sovereign financing available is explained by the strong fiscal situation faced by Ecuador in recent years, based on very high prices for the country's main export, petroleum products. Ecuador's primary fiscal account averaged a surplus of 0.3% of GDP during 2007-2011, even including a sharp deterioration in 2009 to -3.6% as a result of the global crisis (MEF, 2012b). Because of this, Ecuador's public debt has dropped to only 22% of GDP as of June 2012, from a high of 86% in 2000 (MEF, 2012c).

At the same time, however, Ecuador has embarked on a major investment surge, one of President Correa's main political platforms. Capital spending has tripled during his administration, rising from under 5% of GDP in 2006 to 15% in 2011 (MEF, 2012b). The vast majority of the new investment spending has been funded with bilateral loans from the Chinese government. Loans from non-Paris Club governments to Ecuador have risen from US$653 million at the end of 2008 to US$3.2 billion by June 2012 (MEF, 2012d). Of that, the Chinese lent Ecuador US$2.5 billion between 2009 and June 2012, and the Brazilian government another US$250 million (MEF, 2012e). This does not include very large loans (several billion US$) given by the Chinese to the Ecuadoran national oil company, which according to the MCPE are not classified as public debt because they are considered "advanced payments" on future deliveries of petroleum products to the Chinese (León, June 11, 2012). All of the new debt is at very high interest rates, listed as between 5.1 and 8% on MEF data (MEF, 2012f), with former and current ministry officials citing 7% as the standard rate. This more than double the rates offered by the CAF and considerably above the terms provided by the World Bank and IADB (Ibid.). With an average maturity of 12 years, these rates are comparable to the levels considered unsustainable for 10-year sovereign bonds issued by Spain and Italy during the Euro debt crisis.

According to both the MCPE and MEF, Ecuador has been taking the maximum amounts available from both the IADB and CAF, but that this does not come close to covering the country's investment plans, which accounts for the move to borrow from China, despite higher interest rates. "It's not like we can indebt ourselves as much as we would like with these institutions, they all have their limits for each country," said the MCPE vice-minister. "We are using both [IADB and CAF] the most possible, so we've had to look for other sources, which in our case is China. We do need to analyze a bit more the issue of pricing, but there is no limit to the amount of loans we can take out with China" (León, June 11, 2012). The MEF vice-minister confirmed that Ecuador was at the borrowing limit with the CAF and close to the limit with the IADB.

Hence, while demand side issues are a key factor in explaining why Ecuador chooses not to work with the World Bank, despite very attractive financial terms, supply side issues are also relevant. Ecuador would clearly like to borrow more from both the IADB and the CAF, but is unable to because of supply restrictions. In the case of the CAF, the supply restriction comes mainly from the danger of over-exposing the CAF's loan portfolio to a country seen as unstable by financial markets, which could impact its own credit rating and borrowing costs. According to both CAF and Ecuadoran officials, the CAF prefers to keep exposure to a single country below 30% of the total portfolio, and at certain points Ecuador was approaching those limits, which led the CAF to slow down lending (Standard and Poor's, 2010b). The rationale behind the IADB's country exposure limit is more opaque, and there is no way to tell whether this is an objective measure or whether the U.S. or other major shareholders are able to influence this allocation behind the scenes. A former finance minister attributed the reduced size of the IADB's loan portfolio to the tensions between the U.S. and the Correa administration, saying, "The U.S. has an important role in all these boards, the IMF, the World Bank and the IADB. And they [the Ecuadoran government] kicked out the U.S. ambassador. The IADB keeps making loans, although in much smaller amounts than before" (Pozo, June 12, 2012).

6.2.3 Speed and Flexibility are Key Factors; Technical Assistance is Not

While limits on available credit are clearly key to explain the size of Ecuador's portfolio with the CAF and IADB, other factors also play an important role, and go some way to understanding why Ecuador has not taken the maximum amount of loans from the IADB, despite its low cost compared to China and the CAF. The first, according to several MEF officials, is speed and ease of approval, which is particularly important for the current administration's drive to quickly complete major infrastructure investments. The lengthy approval time for IADB investment loans is too long for many of Ecuador's planned projects. "What we put with the IADB are projects that don't need to be executed in the very short term, that can take that time of maturation and processes of the IADB," according the MEF vice-minister. "With China, they can give us US$2 billion in three months, and they just use national laws [for procurement and financial management]. The difference is abysmal" (Almeida, June 12, 2012). A second MEF official in charge of multilateral borrowing said the greater speed of the CAF led Ecuador to use them for many projects over the IADB. "There's important projects that cannot wait, so we go with the CAF. Our government wants to finance these projects quickly, so whoever can give us the resources more quickly, we go with them. Speed is very important" (Villafuerte, June 8, 2012).

As with Colombia, all officials with experience dealing with the three MDBs reported that the World Bank and IADB had roughly similar levels of bureaucracy and time to approval, while the CAF was significantly faster and easier to work with. “The CAF is a lot faster for getting financing, then next is the IADB,” said a MEF official. “In terms of time, the IADB and the World Bank are about the same, in my experience” (Ibid.). A former finance minister, in office during the Gutierrez government and involved in taking loans from all three MDBs, agreed with the assessment of current officials, also adding that if the country was in a hurry they could simply call the CAF president directly to speed up the loan approval (Yepes, June 8, 2012). The MCPE vice-minister pointed to the CAF’s reliance on national legislation as an important factor in its favor. “In the case of CAF financing, the form of spending is subject to national legislation,” he said. “By contrast the spending with the IADB is subject to their methodology of procurement, which is above the national legislation. So in some cases this turns out to a longer the process of contracting. It could be that this has been an incentive to change the source of financing for types of projects.” (León, June 11, 2012).

Another former finance minister, who was in office at the start of the Correa administration in 2007, indicated that not only was the CAF faster and less bureaucratic than the IADB, but that it was also more flexible and willing to adapt to the government’s immediate needs. “The CAF was always close to the country,” he said. “When the Correa government started in a very bad fiscal situation...the CAF accelerated loans that were in the approval process, and made disbursements to keep public works going. They were very close to the needs of the country…They were much faster than the IADB, and much closer to the government” (Ortiz, June 8, 2012).

Several former and current officials also pointed to the lack of safeguards and flexibility in loan use as an added attraction behind the huge rise in borrowing from the Chinese, apart from available supply. “It’s much more effective for the Ecuadoran government to go with China, they don’t demand absolutely anything,” one former finance minister said. “You pay more, its short-term, but you get the money right away and there’s less requirements for economic policy and transparency in contracting” (Yepes, June 8, 2012). As well, the Chinese resources act in effect as budget support lending, as according to MCPE and MEF officials it goes directly into the budget and is not tied to any specific spending. Hence this could explain the lack of concern of Ecuador about losing access to IADB budget support loans.

In stark contrast to the case of Colombia, the expertise and technical assistance that comes along with loans, especially for the World Bank and IADB, is of very low importance to Ecuador. According to current and former officials, this is partly the result of associating technical assistance with the heavy-handed policy impositions of MDBs in past years. "The bad relations of the current government with the multilaterals, especially with the World Bank, came about as a result of these technical assistance, help that came along with the credits. You have to evaluate the impact of this technical assistance, and I would say the balance is negative," said a former finance minister (Ortiz, June 8, 2012). The MEF vice-minister stated that while technical assistance can be useful, it is not a decisive issue for Ecuador. "An interchange of experiences is fine, but you have to adapt it to the country," she said. "These are banks, let's not fool ourselves. You don't take the credit just for the knowledge. What you want is to finance what you've defined as a country as your priorities" (Almeida, June 12, 2012). As in Colombia, the CAF is not perceived as a source of technical assistance, except in some very specialized aspects of infrastructure projects. However, because Ecuador does not value the assistance to the same degree as Colombia, this does not seem to work against the CAF as a source of loans.

6.2.4 Competition for a Sensitive Client

Despite the relatively small size of Ecuador's loan portfolio for all the MDBs, each has engaged in competitive behavior in recent years to maintain or (in the case of the World Bank) re-engage with the country. Because of the political stance of the Ecuadoran government as well as its particular needs and context, this competition has taken on a very different character from the case of Colombia. The focus on technical assistance, sophisticated financial products and easing of policy conditionality are not relevant for Ecuador, while flexibility in resource use and respect for the political sensibilities and more centralized control of national finances by the Correa administration are more useful.

Both the IADB and the CAF have offered Ecuador a number of ways to provide "backdoor" financing directly to the budget, since neither provides direct budget support loans (the IADB because of the IMF dispute and the CAF as a matter of policy). Several current and former officials described how the CAF was able to provide budget support disguised as an investment loan. The loans would be drawn up supporting a specific sector, such as education or infrastructure, and would according to the CAF be paying for sectoral expenses that had already occurred. In reality this simply meant the resources were going directly into the general budget. The current CAF portfolio shows a number of sizeable sectoral loans that, according to descriptions in the annual reports, are not for specific investments, suggesting the CAF has continued this technique under the Correa administration.[63]

The IADB has undertaken similar financial arrangements, although according to MEF and MCPE officials it is much more careful about ensuring that specific sectoral spending is fully documented before such a loan is approved. Nonetheless, the mechanism functions in the same way, essentially replacing spending the government has already done (and presumably would have done anyway) with an injection into the general budget. One former minister described the process as follows: "With the IADB, we found a scheme to identify projects agreed on by the government, and came up with a type of reimbursement. We would do a project with our own resources and then show that it was completed, and use that as the basis to get financing from the IADB, and return liquidity to the budget" (Ortiz, June 8, 2012). Thus, even with the U.S. closing off formal budget loans, the more flexible loan procedures of the IADB allow it to continue providing de facto budget support.

Current officials also pointed to a more circumspect attitude of all three MDBs on their dealings with the Correa administration compared to previous years, for example in how

[63] For example, US$250 million for "social sectors" in 2010 and US$200 million for "debt policy" in 2008.

they go about "marketing" their loans. In previous years, IADB and World Bank officials would try to generate demand for their loans by going directly to executing agencies, who would then come to the MEF for approval, according to MEF officials. "Not any more. Now we say, our development plan is this, our plan of investments is this, these projects are those I would like to do with the IADB or the CAF, and then you start to set up the missions to come and work on the projects that you say you need as a country. And IADB and CAF are fine with that" (Almeida, June 12, 2012). Similarly, the MCPE vice-minister noted a greater degree of humility on the part of the IADB and the World Bank. "In recent years the IADB and World Bank have been much less demanding. In the past they had more of an attitude, but before this government," he said. "Not now. I think the international organizations have a different attitude, because the current government has been very critical of exactly this type of behavior" (León, June 11, 2012).

The World Bank has by all accounts made a concerted effort to restart lending to Ecuador, and although it continues implementing a past project and has engaged in some public events, it has not yet been successful. The effort of the World Bank to restart lending was confirmed by World Bank staff (World Bank interview, May 14, 2012) as well as several current and former Ecuadoran officials. "Yes, they are trying to come back," said the MCPE vice-minister. "There have been many efforts, but politically it's blocked from Ecuador's side. Like any bank, they think like bankers and want to lend money, and so are always looking for a way back, but the government has not opened the way" (León, June 11, 2012).

6.2.5 Summarizing Findings

The case of Ecuador reveals a different set of results to explain trends in MDB lending over recent years. While once again many of the factors analyzed in Chapters 4 and 5 are relevant for Ecuador, the importance placed on them is quite different from the case of Colombia. Here, supply issues seem more relevant than in Colombia, with Ecuadoran officials saying they would borrow greater resources from the CAF and possibly the IADB if possible, and are recurring to more expensive Chinese lending in part simply because of available supply. Price issues are less binding, because Ecuador has no realistic access to private markets and is generally a price-taker to fill its borrowing needs. And because of the current administration's ambitious infrastructure investment program, speed is a key demand-side issue, explaining why IADB lending is not used to the maximum level available, despite a much cheaper price than the Chinese or the CAF. Use of national procedures for procurement and safeguards appeared only of minor concern to the Ecuadorans, perhaps in part because it only arose in the relatively small portfolio of the IADB, which was far outweighed by Chinese lending with no such requirements. Technical assistance, so critical to the Colombians, is by all accounts a non-factor for the Ecuadorans.

The Ecuadoran example did highlight one factor not analyzed in Chapter 5 that could be relevant: the political impact of working or not working with a given MDB. Because of its high-profile legacy in Ecuador—and perhaps in many countries in Latin America and elsewhere in the world—the World Bank could well be viewed with great suspicion and antipathy by parts of the population, and using it as a whipping boy may prove politically useful. Whether this explains Correa's decision to cut off relations with the World Bank (and IMF) is unanswerable, but certainly plausible. The lower profile of the IADB and its more regional character may make it a less useful target for politicians, while the CAF is likely viewed positively, if indeed the general public is even aware of its existence. This political dimension could be worth taking into account more systematically in analyzing the World Bank's lending, especially in countries with strong past World Bank involvement and led by politicians on the left of the political spectrum. This, in turn, also mixes with potential supply side effects of the role of major shareholders (notably the U.S.) in possibly restricting supply to countries for political reasons, as may be the case in Ecuador and has been suggested by other academic studies.

6.3 Conclusion

The research undertaken for this chapter—interviews with high-ranking country officials involved in the multilateral borrowing decision process in Colombia and Ecuador—generated useful evidence to shed further light on the main factors going into MDB borrowing in two developing countries. By interviewing the actual officials involved in borrowing decisions in two countries, this chapter was able to examine the political and economic complexities of real cases, which both test the plausibility of the analysis in Chapters 3-5 and also highlighted certain country-specific realities that point to the need for caution in interpreting aggregate statistical patterns.

In the two cases considered here, the main causal factors posited in the previous chapters as likely shaping demand for loans from each of the three MDBs appear valid, and the position of each of the three MDBs relative to one another in each of these factors was reported to be exactly as found in Chapters 4 and 5. However, their degree of importance varied considerably depending on country circumstances. Price is unsurprisingly a key issue, although much more important for the long-term planning horizon of Colombia than in Ecuador, which is currently focusing on borrowing large volumes for major investment projects due to political reasons. Speed and bureaucratic obstacles are relevant for both countries, but much more so for Ecuador, for the same reasons as above. Safeguards appeared much more troublesome for Colombia, possibly because much of Ecuador's major infrastructure projects (which are most likely to trigger safeguards) are undertaken with Chinese and CAF resources, while the IADB's Ecuador portfolio is more in social areas and the World Bank is not currently lending at all.

At least two other factors not analyzed in Chapters 4 and 5 also arise as potentially important, and should be considered in future analysis of MDB lending. The first is the technical assistance and knowledge component of lending, which for Colombia was considered a top priority in defining the source of an MDB loan, with World Bank considered at a slight advantage over the IADB and the CAF essentially unable to provide these services at all. In the case of Ecuador, however, technical assistance was considered of minor importance because of past negative experience with multilaterals and also the strong nationalistic stance of the current administration in defining its own development strategy. Second, some countries—in this chapter, Ecuador—may find it politically useful to be seen as refusing to work with the World Bank because of its reputation as a purveyor of "neo-liberal" recipes for development, or conversely they might pay a political price for being seen working too closely with the World Bank.

Because of its lower profile and regional character, this seems to be less of an issue with the IADB, and does not arise at all for the CAF.

Another noteworthy finding is the relevance of the relationship between the borrowing country and the United States as an influence on the supply of lending. This arose for both countries analyzed here, with opposite outcomes. For Colombia, high-ranking officials explained their ability to access much higher levels of non-earmarked budget support from both the World Bank and IADB than those MDBs normally provide specifically as a result of the influence of the U.S. administration, with which Colombia has been closely allied for several years. By contrast, the bad relations between Ecuador and the U.S. appear to have led to the IADB shutting off budget support lending to the country and reducing the overall lending envelope available. While this does provide some qualitative support to other studies investigating the role of the U.S. in multilateral lending (for example Harrigan et al., 2006, Dreher et al., 2009, and Kilby, 2006), a note of caution is required, for two reasons. First, in the case of Ecuador this has had at least as much a demand effect as a supply effect (considering Ecuador's refusal to borrow from the World Bank for the past five years, despite the MDB's efforts)—hence the direction of causality cannot be assumed. Second, it is far from clear in these two examples how much the U.S. influence achieved, and it would appear to be only marginal (mainly on the modality of lending). Hence, the evidence here suggests that the U.S. role should not be over-stated.

Lastly, in the context of two countries with increasing options in terms of supply of sovereign lending and much improved fiscal situations, it is interesting to see the degree to which all three MDBs engage in considerable competitive activity to maintain their loan portfolio. Officials in both countries offered many examples of the MDBs working very hard to place loans, which is a far cry from the official line—at least at the IADB and World Bank—that they are simply providing help when needed, and are not in any way "crowding out" other potential private sources of financing. Easing off on policy conditionality, changing staff to suit government needs, developing more innovative financial products, using investment loans as de facto budget support when requested and developing technical assistance specifically as an entrée to sealing project deals are among the many strategies employed by each of the MDBs to continue placing loans. What exactly is driving this competition is an open question—is it a financial need for income generation from loans or secure better access to markets for MDB bonds? Or a bureaucratic drive to expand operations? Or simply a professional desire to remain relevant and "at the table" to influence policy? These are questions worth further investigation, but it is clear that MDBs are in fact acting very much as competitors to hold onto increasingly picky clients.

7 CONCLUSION

The overarching motivation for this thesis has been to better understand how a changing world economy, and in particular the economic rise of many developing countries, is reshaping the operating environment and activities of multilateral development banks (MDBs). In academia and general popular perception, MDBs—and especially the World Bank—are frequently viewed as all-powerful organizations able to impose their will upon helpless developing countries. But in a world where many developing countries no longer need MDB loans as much as they did in previous years, this presumed power dynamic does not hold. China, Brazil, Turkey, South Africa and other middle-income countries have high international reserves, stable fiscal accounts, low debt and access to a variety of sources of finance, including domestic capital markets.

In such a context, many countries only work with MDBs when it suits their own priorities and needs. That is, demand-side factors are much more important in development lending than in the past. This dynamic, in turn, is likely to be having differing effects on the 20-odd MDBs in existence, because of their different operating characteristics and hence attractiveness as a source of loans for borrowing countries. The research has considered these issues by examining three MDBs operating in Latin America: the World Bank, the Inter-American Development Bank (IADB) and the Andean Development Corporation (CAF). Specifically, the thesis has sought to analyze how three separate aspects of multilateral development lending are inter-acting: i) the varying interests and relative power of different MDB shareholding countries; ii) the growing economic strength of many middle-income countries, reshaping their demand for MDB loans; and iii) the pressures faced by MDBs themselves as a result of their financial model.

To establish a basis for formulating testable hypotheses, Chapter 1 reviewed the extent academic literature on international organizations in general and MDBs in particular. With very few exceptions, the literature has up to now focused overwhelmingly on the "supply" side of MDB activity. That is, whether an MDB makes a loan or not is considered almost entirely through the lens of what the MDB itself wants to do, while recipient countries are (explicitly or implicitly) assumed to have a constant demand function for MDB loans. Various hypotheses have been put forth and tested about what motivates the MDB's "supply", including the geopolitical interests of one or two powerful shareholders (mainly the U.S.), changing ideas and norms about how MDBs should promote development, tensions between shareholders and MDB staff or bureaucratic pathologies within the MDB itself. Hence, this thesis' focus on demand-side factors is a potentially valuable contribution to the literature in the interest of building a more comprehensive, realistic explanatory model for MDB activity, especially in the current global economic context.

Despite its predominant supply-side focus, existing IO literature provides two useful theoretical tools to bring to bear in the current research project. The first is a way to help understand how, in a more demand-oriented marketplace for development lending, MDBs might systematically differ from one another in ways that makes them more or less attractive to borrowing countries as a source of lending. Building on the work of a number of scholars using a principal-agent framework for understanding MDBs, I propose a schema that takes the split between borrowing and non-borrowing country shareholders as a critical variable that helps explain numerous operational characteristics for different MDBs. These two groups of countries, I suggest, will tend to have similar interests within their group and divergent interests between the groups, and the relative balance of shareholder voting power between them defines many key aspects of operational policy and activity. Borrowing governments will want MDBs to supply loans and advisory services at as low a cost as possible, with minimum bureaucratic hassles and conditions. Non-borrowing countries, by contrast, will seek to impose their own ideas about development on borrowers, implement strict control on how resources are spent, and reduce the risk of MDB financial difficulties that they would have to pay for out of their guaranteed capital. The relative power of those two groups is a critical variable shaping the competitive advantages of different MDBs from the point of view of borrowing countries

The second theoretical building block comes from organizational sociology, and attempts to understand a fundamental aspect of the MDB organizational model frequently overlooked in the current literature: its character as a financial institution. MDBs are many things, but at bottom their financial model serves as a very specialized sort of bank, one that is largely self-sustaining and requires minimal fiscal contributions from shareholders, and at the same time is capable of providing a variety of what are generally considered to be global public goods. The basic mechanics of this model—borrowing capital at very low rates, lending to developing countries at slightly higher rates and covering operating costs with the margin—embeds certain financial pressures into their organizational model. The two specific needs each MDB faces are i) access to sources of capital at low prices; and ii) a steady stream of borrowers to generate sufficient loan income to pay administrative costs. Combined with the specific interests and balance of power of shareholders within each MDB and the evolving world context, these financial pressures can push MDBs into acting in ways that are not necessarily in accord with their development mandate in order to ensure organizational survival.

As a result of these theoretical considerations, this thesis formulated and set out to test the three hypotheses, the first of which focuses on the internal dynamics of MDBs while the second two address how MDBs relate to borrower countries and the wider external environment in which it operates. The two sets of hypotheses are linked, in that the causal relationships defining the internal dynamics of each MDB in turn condition its relations to borrowers and the external environment.

I. Shareholders and internal MDB dynamics

I. Shareholders and internal MDB dynamics

H1: The balance of power between borrowing and non-borrowing shareholders causally defines key MDB operational characteristics that impact borrower demand, including loan cost and approval requirements, such that:

- The more non-borrowing countries have control over an MDB, the lower will be loan prices, but the more intrusive will be its loan approval requirements

- The more borrower countries have control over an MDB, the higher will be loan prices, but the less intrusive will be its loan approval requirements

II. MDBs, borrowers and the external environment

H2: As a function of a borrowing country's reduced need for MDB loans and greater access to alternative sources of capital, these MDB operational characteristics will become increasingly important in explaining their demand for MDB loans, as opposed to supply factors.

H3: The imperative of securing resources required for MDB organizational survival (i. sources of capital and ii. borrowing country clients) will lead MDBs to modify their operational strategies, organizational structure and even membership to ensure survival.

Section 1 below reviews the results of evidence collection and analysis undertaken in each of the main chapters of the thesis as they related to each of the three hypotheses, and discusses the implications of the study for research on MDBs and IOs more generally. Section 2 concludes by considering implications for MDB policy and reform, and suggests ideas for future research directions.

7.1 Review of Research Findings and Extensions

The qualitative and quantitative evidence accumulated over the course of this research project provides generally strong support for the initial research hypotheses, as reviewed in sub-sections 7.1.1-7.1.3.

7.1.1 Hypothesis 1—Shareholder Balance of Power

Categorizing country shareholder groups appears to be a useful methodological tool for analyzing characteristics and activities of MDBs. Evidence—mainly from interviews undertaken in Chapters 4 and 5—indicates that broad opposition between borrowers and non-borrowers on numerous issues is a critical fault line in the governance of MDBs that shapes both their operational attributes and actions throughout their realm of action and within individual countries. The analysis of these chapters clearly shows that key factors driving operational characteristics of the three MDBs—loan prices, loan processing times, environmental and social safeguards and procurement procedures—fall along a continuum with the CAF at one end, the World Bank at the other, and the IADB in between. Critically, this positioning is shown to be a direct result of the relative interests and balance of power between borrower and non-borrower shareholders, wherein the three MDBs also fall in the same positions along a continuum.

Nonetheless, it must be acknowledged that the "middle ground" position of the IADB does appear more difficult to categorize than the two extremes of the CAF and World Bank. The marginally larger voting share of borrowers in regular loan decisions, coupled with the veto power of the U.S. over major policy changes, make the IADB more problematic to analyze. Evidence from the two case studies in Chapter 6 suggests that the U.S. can leverage the threat of withholding capital increases to gain power on decisions of interest to it. Evidence from Chapters 4 and 5 also indicate that borrowers are able to use their greater voice and voting power to shape policies, for example safeguards and net income allocation. The particular characteristics of the IADB seem to position it as the "best of both worlds" in relation to the other two MDBs: it has many of the advantages that come with non-borrower shareholders (most notably excellent access to capital markets and hence attractive financial terms) as well as some that come with a borrowing shareholder majority (slightly less onerous non-financial hassle factors and greater flexibility than the World Bank, less negative political visibility and a better image with client countries).

To better substantiate the importance of shareholder structure and to address the more methodologically troublesome "middle ground" position of the IADB, it would be necessary to expand the analysis to other MDBs. This would also mitigate the problem of just including a single case for each of the three governance structures. The credibility of the causal link suggested in theoretical argument and empirical research would thus be greatly enhanced if similar relationships could be shown for additional MDBs. If other MDBs were shown to follow the same patterns, this would also exclude that the relationships observed are merely driven by particularities of the Latin American region.

Table 7.1. MDBs by Type of Shareholder Arrangements

Type	MDB	Votes by non-borrowing shareholders (in %)	Non-concessional loans (2008) (in US$ billion)
Non-borrower dominant	World Bank	65.7	13.5
	Asian Development Bank	65.2	8.4
Non-borrower predominant	IADB	49.9	11.1
	African Development Bank	39.7	2.8
	Banco Centroamericáno de Integración Económica	41.0	1.4
	Caribbean Development Bank	35.9	0.3
Borrower dominant	CAF	3.1	7.9
	Islamic Development Bank	0.0	7.2
	East Africa Development Bank	14.1	0.03

Sources: World Bank 2009a, Asian Development Bank 2009, IADB 2009, African Development Bank 2009, Banco Centroamericáno de Integración Económica 2009, Caribbean Development Bank 2009, CAF 2009a, Islamic Development Bank 2009, and East Africa Development Bank 2009.
Note: This table does not include MDBs that lend primarily to the private sector, such as the EBRD and EIB.

While this extension would require a substantial expansion of data collection and analysis that is beyond the scope of this thesis, a classification of other major MDBs further research might want to take into account is provided in Table 7.1. The table considers MDBs that (i) have at least some borrowing countries as shareholders and (ii) lend primarily to sovereign governments as opposed to the private sector. The distinction between different types of governance is based on the share of votes by non-borrowing shareholders. As can be seen, other MDBs with similar distributions of votes as in the three MDBs considered here are available for further research. Moreover, the lending volumes of some of these MDBs are considerable. Nevertheless, the coexistence of similarly large banks with different governance structures within a given region appears to be relatively unique for Latin America. This may restrict the choice of borrower countries in other world regions—an issue one would need to take into account in possible comparisons.

The findings of this thesis also shed further light on principal-agent models that may be of use to future research. From the evidence uncovered here, it appears that principal-agent dynamics vary dramatically in part as a function of how closely aligned are the interests of principals. Divergent interests among principals open a larger "space" for the agent to both develop and pursue its own agenda. This is evident in both the World Bank and IADB, where staff pursue strategies to make their organization more competitive in a changing marketplace. Some of the formal policy changes proposed by staff—such as greater use of country systems, for example—may get shot down by non-borrowing shareholders, but other, less formal tactics such as relaxed implementation of policies or more "friendly" loan negotiations are much more difficult to control by shareholders. This in part explain the many layers of bureaucratic oversight in those two MDBs—these mechanisms are how the shareholding principals attempt to ensure that the staff agents do their bidding. In the CAF, by contrast, the close alignment of shareholders on exactly what the organization is meant to do leads to staff and shareholder interests being much more closely aligned, and as a result the MDB's organization and procedures are considerably less bureaucratic and formalistic than the World Bank or IADB—there is less need for shareholder principal oversight.

7.1.2 Hypothesis 2—Borrower Demand

Evidence considered in Chapters 3-6 supports the hypothesis that shifting the analytical focus more in the direction of borrower demand is necessary to understand the functioning of MDBs in the current global economic context. An exclusive supply side focus may have been a methodologically useful approach to understand MDBs during earlier times, but it is certainly no longer sufficient now. The global economy has changed radically in the past 30 years, and while it remains an open question as to whether current trends continue, it is evident that the world will never return to the situation of the 1980s. Many of the largest MDB clients are in a position of considerable economic strength and the reality of global capital movements mean that vastly larger amounts of finance are now available for development lending. The demands of large middle-income developing countries like China, Brazil, Turkey, South Africa and

Indonesia on MDBs matter a great deal, and ignoring that reality clearly misses a major and perhaps fundamental aspect of MDB activities in the present day.

This is not to say that supply side issues are now irrelevant—far from it. Financial issues are unquestionably important, as discussed in detail in Chapter 4. As well, the role of the U.S. in both the World Bank and IADB—much analyzed in the extant literature on MDBs (for example, Harrigan et al., 2006; Dreher et al., 2009a and 2009b; Kilby, 2006and 2011; and Lim and Vreeland, 2011)—is certainly still relevant, considering that country's veto power over major aspects of policy and organizational structure. This was shown to be the case in the current thesis, statistically in Chapter 3 and through the interviews undertaken in both Colombia and Ecuador. However, this and other studies find a relatively marginal significance for U.S. influence. The U.S. is evidently not shy about exercising both formal and informal power when it sees fit. At the same time, the U.S. government obviously has neither the ability nor inclination to micro-manage thousands of development operations of many types undertaken by the World Bank and IADB each year. The vast majority of these operations, one must assume, are driven by other concerns.

One also cannot discount supply-side views of MDBs derived from a more constructivist perspective. The internal intellectual and professional culture of different MDBs, the self-image of the staff and evolving norms and ideas on what "development" means and how best to pursue it are likely to play a role in shaping MDB actions. These topics were not a focus of this thesis, but did come up in the case study discussion of the varying interaction styles of mission teams from the three MDBs with government officials as well as the move toward country systems as part of the Paris Declaration agenda, despite resistance from major non-borrowing shareholders. Another example not discussed in the thesis is how development "fads" shape lending trends (decentralization in the 1990s, conditional cash transfers in the early 2000s, performance-based budgeting in the mid-2000s).

However, this thesis shows that supply considerations must be complemented with the perspective of the borrower. The case studies of Colombia and Ecuador make it evident that government officials can and do compare MDBs to one another and to other potential sources of sovereign borrowing, using a number of criteria depending on their political and economic circumstances. Loan price and bureaucratic requirements that come along with the loans—as analyzed in Chapters 4 and 5—are major considerations, as are other attributes such as the quality of an MDB's technical assistance and political/ideological considerations. It is abundantly clear that trying to understand development lending in the early 21st century without considering the views of borrowing countries is not possible.

The case studies illustrate that the priority placed on MDB characteristics appears to vary from country to country, and even over time within a single country, making broad generalizations difficult. As with Hypothesis 1 above, this leads one to consider broadening the scope of countries considered, both as case studies as well as in aggregate statistical analysis. The countries examined in the preceding chapters are largely fast-growing middle-income countries. Do these same patterns hold true, for example, in smaller, less developed regions of the world? What about Central America, where three MDBs also operate (World Bank, IADB, and the Banco Centroamericano de Integración Económica)? Do countries with lower levels of economic development, such as parts of south Asia or sub-Saharan Africa, face different dynamics because of their dependence on highly-concessional lending windows such as IDA, or is the rise in alternate sources of capital (for example, Chinese investment) impacting borrower demand there also?

7.1.3 Hypothesis 3—Financial Pressures

The thesis uncovered convincing evidence in support of the importance of financial considerations in driving MDB activities. This was particularly apparent in Chapter 2, which showed how the need to access capital markets shifted each of the three MDBs to some degree away from original conception of their founders. As a number of European countries have recently been made aware, international bond buyers are a rather unsentimental bunch, easily swayed to put their money elsewhere if they sense danger. The World Bank, IADB and CAF all learned this lesson the hard way. In the interests of keeping bond buyers satisfied, they reshaped their lending strategies and even—in the case of the IADB and CAF—their very shareholding structure. In light of the unwillingness of shareholders to contribute larger sums of capital for on-lending directly out of their budgets, there was simply no alternative if these MDBs wanted to continue as viable developmental organizations.

While this need to placate the capital markets may have come at some cost to their developmental mission, it also is a source of considerable strength and autonomy. MDBs—unlike many other international organizations such as the United Nations—do not depend on budgetary handouts.[64] As country shareholders do not have the "power of the purse" in an absolute sense, MDBs have more room to maneuver on their own terms, opening the door perhaps wider to principal-agent dynamics and more constructivist-oriented bureaucratic self-motivation than in other organizations controlled more directly through annual budget allocations like, for example, the United Nations. This also explains why the intermittent capital increases and tri-annual IDA replenishments are such lengthy and fraught affairs—these are the opportunities for major shareholders to further their interests. In the words of Kapur, IDA replenishments have become "the tail that wags the dog" (2000, p. 34), exactly because it is the best opportunity for the U.S. and other major shareholders to force through policy changes at the relatively autonomous IBRD.

The pressure faced by MDBs in securing the resources they need to operate from international capital markets is a little-explored facet of their organizational model. While this thesis looked into the impacts of this relationship historically (in Chapter 2) and as a factor influencing loan pricing (Chapter 4), considerable research could still be undertaken in this direction. The interaction between MDBs, bond rating agencies and

[64] This has an interesting—and perhaps related—parallel with the story told about New York City builder extraordinaire, Robert Moses, in Caro's 1974 masterpiece, *The Power Broker*. By designing the Triborough Authority in such a way that it could issue its own bonds, payable with toll revenues, Moses made himself independent from city, state and even national authorities for decades, with immense consequences for New York City's infrastructure. Moses' Triborough bonds were a favorite of Wall Street bankers in the 1930s and 1940s, and one can imagine that the World Bank's initial designers and the Wall Street crowd who first led the World Bank (see Chapter 2) may have been well aware of the financial and other benefits of establishing good relations with bond markets.

international capital markets is complex and has a major impact on financial and even developmental policies at MDBs. According to interviews with World Bank EDs, they face regular pressure by the World Bank Treasury to comply with its requests, "so we keep the bond markets happy," said one (World Bank ED interview, January 25, 2012). "And we don't know enough about it to question Treasury, so we just agree." Further, more detailed statistical analysis could be done with the performance of MDB bonds in different market conditions and the link with loan prices, thus more exactly pinpointing divergences that might be caused by non-financial factors.

The other critical financial resource built into the MDB organizational model is, of course, the interest earned on making loans. MDBs are banks, and banks earn their revenues (mainly) through loans. As such, it should come as no surprise that the case studies of Colombia and Ecuador revealed considerable evidence of competitive behavior on the part of MDBs. Backing off on policy conditionality, offering new, more flexible types of financial instruments, using technical assistance as a carrot to launch loan projects and adopting more diplomatic interactions with country governments are just some of the strategies MDBs are using in Colombia and Ecuador. This pressure to make loans—built into their organizational model—makes MDBs far more entrepreneurial than other types of public bureaucracies, with many characteristics closer to a private business.

While the thesis has considered some of the competitive behaviors undertaken by MDBs to make loans in the context of the two case study countries, this is another area with considerable potential for further research. The competitive strategies discussed in the context of Colombia and Ecuador are unlikely to be an exhaustive account. Research could explore how MDBs are competing in different country contexts, by undertaking a more detailed review of country portfolios and interviewing government officials and MDB staff on this specific issue. How does this play out in different country contexts and among different MDBs? A game-theoretical framework—like, for example, the bargaining framework utilized by Mosley et al. (1995) in their path-breaking study on World Bank conditionality—could be useful in this context.

7.2 Policy Implications

The findings of this thesis related to borrower demand, shareholding structure and MDB finances have a number of implications for the future of the global development lending architecture.

The fundamental importance of shareholding structure in shaping MDB characteristics defines lending demand from different MDBs. These trends appear to be notably negative in the case of the World Bank. It seems that the interests and power of non-borrower countries in the governance of the World Bank, and the organizational characteristics that derive from them, are leading to a long-term decline in lending demand from that MDB. While World Bank loans are extremely well-priced, due in large part to the backing of wealthy industrialized countries, the bureaucratic hassles and policy prescriptions that those same countries impose are unattractive to borrowers. As developing countries find themselves in stronger fiscal positions and with expanding opportunities for financing, these hassle factors assume a greater importance in the calculus of borrowers. Temporary crisis, such as the 2008-09 global financial crisis, may drive up lending in the short term, but long-term trends remain unchanged, as the World Bank itself acknowledges in a 2010 strategy paper (2010f).

This, in turn, could have important implications for the World Bank's role in development promotion. It could be that the World Bank becomes primarily a source of lending only for poorer IDA-eligible countries, and to more developed countries only in the case of a temporary crisis. Under such circumstances, it is not at all clear that it would be sustainable under its current financial model. As well, this might impact its ability to both amass and propagate its development expertise, and play a role as a global coordinator in many development issues. The repeated efforts in the past decade driven by the World Bank staff to reform and simplify lending procedures—for example, the Middle-Income Strategy (World Bank, 2001a, 2004a and 2007a), Investment Lending Reform (World Bank, 2009a), Country Systems (World Bank, 2010e) and the P4R lending instrument (2011a)—shows that they are well aware of this problem. These efforts have been whole-heartedly supported by borrower shareholders, but as shown in Chapter 5, non-borrowers have resisted.

Faced with this reality of declining—or at any rate much more selective—borrower demand, non-borrower shareholders face a decision of either reconsidering their stance on non-financial characteristics of the World Bank highlighted in Chapters 5 and 6, to ensure it remains the pre-eminent MDB, or instead reducing its size or reorienting its mission in light of the changing global economic context. A third option would be to build a new type of financial model that does not depend on loan income to sustain the organization and pay for the many global public goods that the World Bank is expected to provide. A tentative move in this direction was launched in 2009 with the creation of the Long-Term Income Portfolio (World Bank, 2011e), which is essentially a pool of income to be invested by the World Bank Treasury in more risky and profitable investments than the normal investment portfolio, and hence generate a more steady stream of net income. While this holds out the possibility of generating sufficient non-loan income to cover administrative costs, and even sufficient net income to suit the purposes described in Chapter 4, it remains to be seen whether shareholders will be willing to allow the World Bank Treasury to act essentially as investment bankers, gambling with a substantial chunk of liquidity to generate income.

Another possibility is to develop new revenue-generating business lines, for example by ramping up the nascent "fee-for-services" pilot, in which the World Bank charges countries to act essentially as a public sector management consultancy (World Bank, 2008b). Currently this operates on a small scale, and the fees charged are (according to World Bank staff interviewed) heavily subsidized below their true cost. Whether this could turn into a viable, stand-alone business line remains to be seen, particularly as much of the World Bank's vaunted "knowledge" comes in fact from its engagement with country lending operations. Other business lines include the explosive growth of trust funds administered (for a fee) by the World Bank (World Bank, 2012g), its involvement in climate financial mechanisms such as CDM (Michaelowa and Michaelowa, 2011) and the newly-proposed climate funds and a little-publicized asset management business started by the World Bank Treasury to help manage developing country assets such as pension funds and central bank reserves (World Bank, 2012h). Whether these business lines are a distraction from the core mission that shareholders envision for the World Bank is an open question. But in the absence of strong and decided action by shareholders to address the themes examined in this thesis and their financial implications, the entrepreneurial staff of the World Bank is understandably—and perhaps commendably—taking whatever action they can to square the circle of their organization's structure and policies with global economic realities and evolving borrower demand.

Within the rules and policies set by shareholders, the World Bank staff themselves have been engaged in very creative entrepreneurial behavior to maintain relevance and continue generating income to ensure organizational survival. In part this has manifested itself in the competitive behavior to make loans discussed in the previous section. The implications of this competition for the development impacts of World Bank operations, and on potentially crowding out private activity, needs to be examined closely. One might be tempted to assume that this competition is somehow inherently detrimental to development goals, but that is an empirical question. Is it necessarily bad, for example, that the World Bank is becoming less dictatorial with its policy conditionality to middle-income countries? After all, this puts the country much more in the driver's seat of its own development. Further, does this activity reduce the flow of private capital to developing countries? Again, this is an empirical question—perhaps the World Bank and other MDBs are funding projects that private capital would view as too risky, or perhaps these loans actually attracts private investors ("crowding in") due to the perception of reduced risk.

While the World Bank struggles with the issues described above, regional and sub-regional MDBs around the world may become the preferred source of development lending by many countries. Smaller MDBs such as the CAF are very "client-friendly", with flexible and easy procedures and no attempt to impose policy prescriptions on borrowers, but the downside is the cost of their loans is relatively higher (sometimes, as in the case of Colombia, even higher than the country can access itself), lending volumes are more restricted and technical assistance is minimal. Larger regional MDBs, such as the IADB, have many of the positive attributes of the World Bank—notably the ability to provide large volumes of low-priced loans, with some level of technical assistance along with them—while avoiding some of the worst excesses of the World Bank in terms of bureaucratic hassle factor and policy impositions.

Recognizing this reality, some observers of MDB activities have already suggested (notably IDS, 2000, Griffith-Jones et al., 2008, and Grabel, 2012) that the development aid architecture should move more in the direction of regional and sub-regional MDBs, which can bring to bear their more localized expertise and good country relations to promote better developmental outcomes. The World Bank could then move into a more coordinating and knowledge role, linking formally with other MDBs, while reducing its direct financing role. This would still leave problems to resolve for the World Bank's financial model discussed above, but has the potential to move toward a more coherent aid system better attuned to the needs of individual regions and countries.

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Interviews

CAF Executive Directors

Five country officials listed below (noted in parenthesis in the Colombia and Ecuador interview list below)

Former Latin American Executive Director, December 19, 2011, anonymity requested

CAF Staff

CAF Operations staff, May 25, 2009
CAF former staff, at time of interview working as World Bank staff, June 1, 2009
CAF Treasury staff, December 14, 2010
CAF former environment staff, June 22, 2011
CAF management, August 23, 2011
CAF top management, August 24, 2011
CAF/IADB former environment staff, at time of interview working as World Bank staff, September 6, 2011

IADB Executive Director/Alternate Executive Directors

Former Brazil Executive Director Rogério Studart, (now with World Bank), December 12, 2011

Former Latin American Executive Director, December 19, 2011, anonymity requested

IADB Brazil Executive Director Sérgio Portugal, January 10, 2012

IADB Argentina Executive Director Eugenio Díaz-Bonilla, January 13, 2012

IADB European G7 Alternate Executive Director, January 13, 2012, anonymity requested

Latin American Executive Director, January 19, 2012, anonymity requested

IADB Chile Executive Director Alejandro Foxley, January 24, 2012, personal views

IADB Latin American Executive Director staff, January 24, 2012, anonymity requested

IADB European G7 Alternate Executive Director, January 31, 2012, anonymity requested

IADB staff

Former operations staff, April 3, 2009

IADB Treasury staff, November 15, 2010

CAF/IADB former environment staff, at time of interview working as World Bank staff, September 6, 2011

IADB environment operations staff, December 7, 2011

IADB operations strategy staff, January 18, 2012

IADB operations staff, January 24, 2012

IADB operations strategy staff, January 24, 2012

IADB procurement specialist, April 27, 2012

World Bank Executive Director/Alternate Executive Directors

World Bank Brazil Executive Director Rogério Studart, December 12, 2011 (previously served as IADB ED)

World Bank Latin American Alternate Executive Director, December 14, 2011, anonymity requested

Former Latin American Executive Director, December 19, 2011, anonymity requested

World Bank Swiss Executive Director Jorg Frieden, January 13, 2012, personal views

World Bank Latin American Alternate Executive Director, January 25, 2012, anonymity requested

World Bank European Executive Director interview, January 25, 2012, anonymity requested

World Bank European Executive Director staff, January 30, 2012, anonymity requested

World Bank U.S. Executive Director Ian Solomon, January 30, 2012

World Bank Staff

World Bank Treasury staff 1, January 20, 2009

World Bank Treasury staff 2, November 5, 2009

World Bank Treasury staff 3, November 17, 2009

World Bank Treasury staff 4, September 15, 2010

World Bank Corporate Finance official, January 20, 2011

World Bank Latin America operations staff, former country manager, January 25, 2012

World Bank Latin America operations staff, January 31, 2012

World Bank environment staff, former with CAF and IADB, September 6, 2011

World Bank OPCS staff, September 7, 2011

World Bank OPCS staff, October 4, 2011

World Bank OPCS staff, January 12, 2012

World Bank procurement specialist, April 24, 2012

World Bank Ecuador team staffer, May 14, 2012

Ratings Agencies

FitchRatings, Franklin Santarelli, Senior Director and lead analyst for CAF, November 22, 2010

Standard and Poor’s, John Chambers, head of sovereign credit analysis, August 9, 2012.

Moody’s, Steven Hess, Senior Credit Officer and lead analyst for World Bank, August 13, 2012

Former ratings agency analyst, August 20, 2012, anonymity requested

Colombia

Alejandro Gaviria, former Deputy Director of DNP (2002-2004), interviewed on June 6, 2012

Carolina Rojas, former sub-director of External Financing (2009-2011) and current advisor to the vice-minister, MHCP, May 29, 2012

Miguel Ángel Gómez, Sub-Director of External Financing, MHCP, May 29, 2012

Francisco Lloreda, former minister of Education (1999-2001), current advisor to the president, May 29, 2012

Juan Mauricio Ramírez, former Deputy Director of DNP (2009-2011) and current sub-director of Fedesarrollo, May 30, 2012

Óscar Iván Zuluaga, former MHCP minister (2007-2010), May 30, 2012 (also served as country representative to CAF)

Olga Bautista, Director of Multilateral Credit at Environment Ministry (2010-2012), June 1, 2012

Santiago Montenegro, former director of DNP (2002-2006), June 1, 2012 (also served as country representative to CAF)

Natalia Bargans, Director of External Credit for DNP (2007-2012), June 6, 2012

María Ines Agudelo, former MHCP official (1999-2006) including vice-minister, also high-level official in the Transport Ministry (2010), Director of Fogafin (2012), June 7, 2012

Ecuador

Fausto Ortiz, former minister of finance (2007-2008), June 8, 2012 (also served as country representative to CAF)

Luis Villafuerte, sub-secretary of public credit, June 8, 2012

Milton Coronel, advisor to sub-secretary of public credit, June 8, 2012

Mauricio Yepes, former minister of finance (2004-2005), June 8, 2012 (also served as country representative to CAF)

Mauricio Leon, Vice-Minister, Ministry of Economic Policy Coordination, June 11, 2012

Alexandra Lastra, Monitoring and Evaluation Coordinator, Ministry of Economic Policy Coordination, June 11, 2012

María Dolores Almeida, Vice-Minister of Finance, former sub-secretary of public investment (2000-2002), June 12, 2012

Mauricio Pozo, former minister of finance (2003-2004), June 12, 2012 (also served as country representative to CAF)

9 ANNEXES

9.1 Annex 1: Alternative Regression Specifications[65]

In the context of the research question for Chapter 3, the choice of the correct econometric model is not obvious. Since lending is a censored variable (no values below zero), as opposed to the linear model presented in the main body of the text, a tobit model might have been a natural choice. Since the tobit model may not be valid if there is a large jump between zero and the smallest positive values, a per capita specification (USD per capita) of the dependent variable is used, as opposed to absolute volume. Regression (1) in Table A2.1 below presents the standard panel tobit model. Unfortunately, this specification uses random rather (RE) than fixed effects (FE), because the fixed effects in non-linear panel models tend to generate bias (incidental parameters problem). Greene (2004), however, shows that in the case of tobit (rather than probit), the bias mainly affects the variance (and terms that are calculated using the variance, such as the marginal effects on expected lending), but not the coefficient estimates themselves. He further argues that omitting the FE may lead to much greater bias. In this case, the Hausman test on the linear specification indicates that the inclusion of country specific effects (here: country×bank specific effects, i.e., country FE that may also vary between the three banks) is indeed highly relevant to avoid bias. Thus a tobit regression with FE (Regression 2) is added. The coefficient estimates, i.e. the marginal effects on the latent variable rather than the marginal effects on expected lending, are presented for both tobit regressions. This avoids bias in Regression 2 and makes the results comparable between regressions. In addition, it facilitates the interpretation of the interaction terms. In any case, the latent variable in these models, interpreted as the willingness to borrow, is a rather meaningful concept.

The problem remains that in Regression 2 variances, and thus standard errors and p-values, are biased downward. However, only about 7% of the observations (22 out of 300) are effectively censored (i.e., =0), so that, first, the tobit FE-model should not be too

[65] This annex was written by Dr. Katharina Michaelowa.

different from a linear FE-model (so that the bias should not be very strong), and second, directly going for a linear RE-model may be a good alternative.

Regression 3 thus presents a simple panel FE-model corresponding largely to the model presented in Chapter 3. The difference is that in this annex, the dependent variable is always specified in per capita terms, and the three banks are taken together in a single lending regression identifying the differences between banks through interaction effects rather than through Wald tests across SURE regressions. Regression 4 further varies the specification of the model by using logs rather than the direct value of the variables (for all variables except the linear trend (year) and the global crisis dummy).

The presentation of the regressions in Table A2.1 should be read as follows. The upper part of all regressions show coefficient estimates for the World Bank (comparable to column 1 in Table 3.3, Chapter 3). The second part of the regressions includes all variables again, but interacted with a dummy variable for the IADB. The resulting coefficient estimates correspond to the additional effect for the IADB and shows whether this additional effect is significant (corresponding to column 4 in Table 3.3, Chapter 3). Finally, the third part of the regressions includes coefficients for the interaction terms of all variables with a dummy for the CAF and can be interpreted in analogy to the interaction effects with the IADB dummy. (The last part corresponds to column 5 in Table 3.3, Chapter 3.)

The comparison between Regressions 1 and 2 shows considerable differences in coefficient estimates notably with respect to the effects of the time trend and the economic variables – effects that seem to be reversed. As discussed above, while p-values may be questionable, the coefficient estimates should be unbiased in Regression 2. This confirms the importance of the FE and suggests that Regression 1 is severely biased. While the coefficient for GDP per capita in Regression 1 points in the expected direction, this is an artifact of omitted country specific effects, and cannot be reproduced in the other (more reliable) specifications.

Annex Table A1.1. Four Alternative Regression Specifications (All MDBs Combined)

Specification	(1) Tobit², RE	(2) Tobit², FE	(3) Linear FE regression	(4) Linear FE, variables in logs²
Dependent variable	Lending per capita	Lending per capita	Lending per capita	Lending per capita
Year	0.295	-1.534**	-1.382**	0.167
	(0.196)	(0.031)	(0.044)	(0.424)
Investor ranking	-0.221	-0.687**	-0.629**	-1.855**
	(0.304)	(0.026)	(0.037)	(0.027)
Reserves (% ext. debt)	0.064	0.120	0.171	0.252
	(0.873)	(0.783)	(0.674)	(0.280)
GDP per capita	-0.002**	0.010***	0.007**	3.285
	(0.028)	(0.003)	(0.012)	(0.177)
Global crisis	-5.464	-5.276	-3.596	-0.242
	(0.147)	(0.135)	(0.307)	(0.367)
UN voting with US (share)	51.623***	26.685*	16.264	1.663
	(0.000)	(0.063)	(0.221)	(0.108)
Inflation (%)	-0.005	-0.006*	-0.003**	-0.443***
	(0.124)	(0.058)	(0.041)	(0.005)
IMF lending (mio USD)	0.001	0.002	0.001	0.053
	(0.818)	(0.613)	(0.747)	(0.283)
Population (mio)	0.520***	2.099*	2.458**	-14.427
	(0.004)	(0.079)	(0.039)	(0.210)
Year × IADB	0.012**	0.265	0.082	-0.118
	(0.030)	(0.785)	(0.932)	(0.689)
Investor ranking × IADB	0.052	0.197	0.136	0.278
	(0.853)	(0.642)	(0.748)	(0.814)
Reserves × IADB	-0.113	-0.179	-0.229	-0.054
	(0.834)	(0.761)	(0.690)	(0.871)
GDP per capita × IADB	0.001	-0.002	0.001	1.252
	(0.160)	(0.649)	(0.754)	(0.715)
Global crisis × IADB	9.947*	10.237**	8.519*	0.609
	(0.054)	(0.037)	(0.088)	(0.110)
UN voting with US×IADB	-40.829***	-38.442**	-28.840	-3.003**
	(0.001)	(0.046)	(0.125)	(0.040)
Inflation × IADB	0.008**	0.008**	0.006**	0.237
	(0.025)	(0.020)	(0.017)	(0.279)
IMF lending × IADB	-0.001	-0.001	-0.001	-0.048
	(0.893)	(0.781)	(0.878)	(0.492)
Population × IADB	-0.406*	-0.706	-1.032	6.384
	(0.098)	(0.670)	(0.537)	(0.694)
Year × CAF	0.026***	3.699***	3.456***	-0.211
	(0.000)	(0.000)	(0.000)	(0.475)
Investor ranking × CAF	0.767***	1.141***	1.086**	3.546***
	(0.007)	(0.007)	(0.011)	(0.003)
Reserves × CAF	-0.448	-0.327	-0.378	-0.496
	(0.408)	(0.578)	(0.511)	(0.133)
GDP per capita × CAF	0.001	-0.014***	-0.010***	-4.889
	(0.439)	(0.002)	(0.010)	(0.155)
Global crisis × CAF	1.571	-1.457	-3.185	-0.219
	(0.761)	(0.767)	(0.522)	(0.565)
UN voting with US × CAF	-81.973***	-27.423	-17.852	-1.223
	(0.000)	(0.155)	(0.342)	(0.402)
Inflation × CAF	0.006	0.008**	0.005**	0.699***
	(0.101)	(0.025)	(0.026)	(0.002)
IMF lending × CAF	-0.006	-0.003	-0.006	-0.114
	(0.312)	(0.286)	(0.599)	(0.103)
Population × CAF	-1.476***	-4.758***	-5.000***	22.318
	(0.000)	(0.004)	(0.003)	(0.170)

Table A1.1 continued

Observations	300	300	300	300
Number of groups	15	15	15	15
R^2 (within)			0.283	0.303
Left censored observations	22	22		
Wald test	$chi^2(27)=143$	$chi^2(41)=220$		
	0.00	0.00		

[1] P-values in parentheses (*** p<0.01, ** p<0.05, * p<0.1). FE (or constant) not shown. IADB and CAF are indicator variables for the respective banks. All fixed effects (FE) and random effects (RE) are at the bank × country level. All variables except year are included with a one-year lag.
[2] For tobit regressions the coefficients rather than the marginal effects on E(y) are shown. They represent the marginal effect for the latent variable and are generally consistent in tobit FE-regressions (specification 2), despite the incidential parameter problem. However, the standard errors may be biased downward in this case (Greene 2004).
[3] All variables are in logs except the global crisis dummy and the linear trend variable (year). For variables (x) with values of zero, ln(1+x) was taken. For inflation 1.2 was added to compensate for a slightly negative value.

Regressions 2 and 3 generally confirm the results from the SURE regressions. While coefficients appear considerably smaller, this is due to the specification of the dependent variable in per capita terms. As before, the linear trend and improvements in the investors' ranking are associated with a significant reduction in World Bank lending. The situation is not significantly different for World Bank lending, while it is (and strongly significantly so) for the CAF. The global crisis variable is not significant for the World Bank and the CAF, but the effect on the IADB is significantly different and points in the opposite direction. Results for control variables also look quite similar (with the exception of the population, which, of course, has a different meaning here, since the dependent variable is itself measured per capita). Only the UN voting variable loses its significance in Regression 3.

Regression 4 shows coefficients that reflect elasticities. Regarding the control variable for UN voting, at least the difference to the IADB again becomes significant (as compared to Regression 3). However, one of the key explanatory variables, namely the trend variable, loses significance. This might simply indicate that the trend observed is indeed best approximated by a linear relationship, rather than by a relationship between years and log lending. Otherwise, the results are similar to those in Regressions 2 and 3, i.e., they are also broadly in line with the SURE regressions presented in Chapter 3.

9.2 Annex 2: Comparing the Pricing of MDB Loans

Comparing loan costs among MDBs would be a useful variable, both in statistical models and more broadly, to better understand differences among them and borrower demand. However, this is no simple task. The first complicating issue for cost comparison is that MDB loan products and terms have varied considerably over time, and most MDBs currently offer a menu of options to borrowers. For much of their history, both the World Bank and the IADB offered a single type of loan for non-concessional borrowers: a loan with a fixed (as opposed to floating) interest rate markup over the MDB's own cost of borrowing, a single maturity, disbursement and repayment schedule, and always in U.S. dollars. Both MDBs added a mark-up over the cost of borrowing to cover administrative costs and generate a certain level of net income. Because loans were disbursed and repaid over many years, this led to both MDBs being exposed to a certain degree of interest rate risk—if their own cost of borrowing were to increase, but the contractual interest rate to borrowers did not adjust, it would result in a smaller spread or even a loss for the MDB.

When interest rates began rising sharply in the early 1980s, the World Bank began to face severe financial difficulties because of this dynamic. As a result, the World Bank modified the fees it charged on loans and changed to a variable spread lending rate system, in which rates were adjusted semi-annually to reflect the World Bank's evolving cost of borrowing. This placed the risk of interest rate fluctuations on the borrower, rather than the World Bank. In response to requests from borrowers, a fixed-spread loan product was reintroduced in 1995, now including a risk premium that made the loan considerably more expensive than variable rates, to compensate for the World Bank's potential interest rate risk. With some modifications, this basic two-option system continues today. Borrowers can chose from either a fixed or variable spread over the London Inter-bank Offer Rate (Libor), the former with an added risk premium charge.[66] The IADB has generally followed the World Bank's lead in this regard, although with somewhat of a

[66] Historical information on World Bank loan terms comes from World Bank 2007b, Annex 1; current terms are detailed on the World Bank's webpage at http://treasury.worldbank.org/bdm/pdf/Pricing_Basics.pdf.

time lag. Currently it also offers a fixed-spread and a variable spread loan instrument. [67] The CAF, by contrast, has always worked with variable spread loans, and only recently instituted a fixed spread option for borrowers.[68] Apart from these changes in interest rates, all three MDBs have at different times offered options regarding maturities, disbursement and repayments, currencies, and interest rate and/or foreign exchange rate hedging instruments. The intricacies of these differences need not concern us overly here.

The main point to take away is that one cannot simply compare the interest rate on different MDB loans over time, since the World Bank and IADB offer more than one type of loan, and loan types have varied within the same MDB over the years. Comparing the interest rate on a variable spread loan based on Libor with a fixed spread loan based on an MDB's cost of funding is to compare apples and oranges. To deal with this, I compare two main lending instruments: (i) Libor-based variable spread loans and (ii) adjustable spread loans based over MDB cost of funding, rather than over Libor. The Libor loans began in 1995 for the World Bank and 2003 for the IADB, and are available from 1996 to 2009 for the CAF.[69] The adjustable spread loans began in 1996 for the World Bank and 1997 for the IADB. They were discontinued by the World Bank in 2009, and were never offered by the CAF. While these two series are far from ideal, they do offer a reasonable basis of comparison for similar loan instruments across the MDBs for a number of years, to give at least an approximation of different costs faced by borrowers.

A second major complication in comparing the loan costs of MDBs is the use of fees, which are added on to the interest rate of the loan. Fees for all three MDBs come in two varieties: a front-end fee and a commitment fee. A front-end fee is simply a one-time charge intended to cover the costs of preparing and administering the loan, and is similar to fees used by private banks. The commitment fee is a charge on all undisbursed loan amounts, and is unique to MDBs, since of course private lending institutions disburse

[67] Current IADB loan terms can be viewed at http://www.iadb.org/en/about-us/idb-financing/financial-terms-of-loans,6037.html; historical interest rates and fees are available at http://www.iadb.org/en/about-us/idb-financing/interest-rates,6050.html and http://www.iadb.org/en/about-us/idb-financing/ordinary-capital-loan-charges,6052.html, respectively.
[68] Information on CAF loan terms (both historical and current) was made available to the author by CAF Treasury officials (CAF 2009a).
[69] CAF used Libor-based loans earlier, but only made data available to the author from 1996.

loans immediately in their entirety. The commitment fee is intended to cover the MDB's carrying cost of holding in liquid assets to cover the undisbursed loan amount (instead of putting it to another, more profitable use), and serves to encourage borrowers to disburse their loans in a timely manner. This is a particular problem for MDBs in long-term investment projects that are delayed for various reasons, such as lack of country counterpart funding. Fees have varied widely between each MDB and over time (Figures A2.1 and A2.2). Because of the considerable additional cost they imply for borrowers, all fees must be taken into account to give a realistic comparison of borrowing costs from each MDB.

Figure A2.1: MDB Commitment Fees

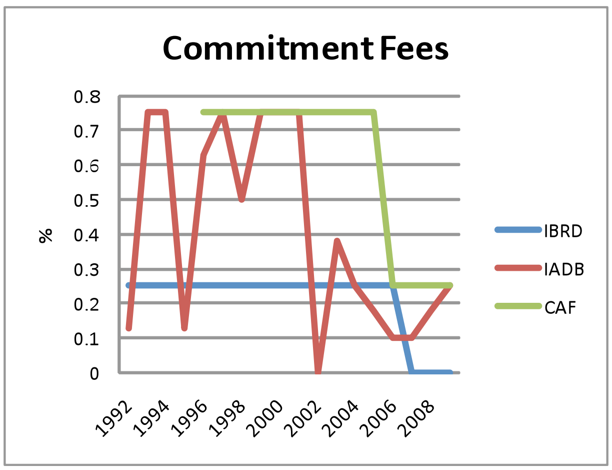
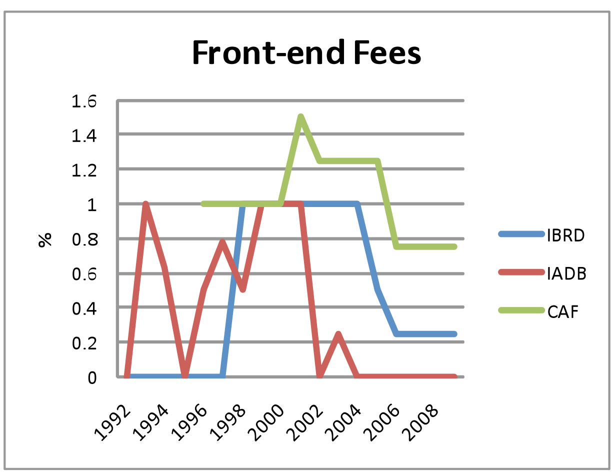


Figure A2.2: MDB Front-end Fees



Source: World Bank 2011c; IADB 2011b, using the average of semester rates for each year; CAF 2009b.

To incorporate loan fees into the annual interest rate and arrive at a single comparable annual "all-in" cost for each MDB, I utilize a methodology employed by the World Bank Treasury for generating comparisons between the cost of World Bank loans and other MDBs in a given year. This involves generating an annualized value for each of the fees, over the entire life of a loan, and adding that on to the annual interest rate charge. It is important to note that the methodology is of necessity not exact. To make an exact comparison would require including the maturity and disbursement/repayment profile for each loan undertaken by an MDB—obviously a monumental task even for a single year, much less over several years. Instead, the World Bank Treasury methodology assumes an average loan maturity of 17 years and a standardized disbursement/repayment profile. While these assumptions do not hold in reality, they do allow for a useful and relatively accurate comparison between the total cost borrowers face from each MDB. Using this methodology, I compare all-in loan costs (interest rate and annualized fees) for the two types of loans mentioned above for the MDBs in question.[70]

[70] An Excel spreadsheet with the formulas used by the World Bank was provided to the author by World Bank Treasury staff in November 2010.