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Only a mid-life crisis? The future for IFIs in an integrated world

Christopher Hurst and Eric Perée

Will you still need me,
Will you still feed me,
When I'm 64?

**John Lennon
and Paul McCartney**

1. Introduction

The European Investment Bank (EIB) differs from most other international financial institutions (IFIs) in that it lends in all of its member countries, not only in its poorer members. It does lend throughout the world, but most of its lending is within the European Union (EU). A significant share is within some of the world's wealthiest countries.

There is nothing new to this situation, and the EIB has survived as the oldest of the regional IFIs. What has changed is the speed of economic integration in Europe. The Single Market, eliminating barriers to intra-EU trade in financial services, has been put in place, and the end of this year will see the launch of EMU. The question of the appropriate role for the EIB in the next century would seem to be even more challenging than that of other IFIs, operating exclusively in countries where substantial poverty continues to exist (1).

Though this paper does not address the particular role of the EIB, this has nonetheless led us back to first principles and a consideration of how IFIs can add value in general. Certainly, this exercise runs the risk of existentialist angst, but when looking to the future we do have to face the possibility that euthanasia may be one of the best solutions to the problems of ageing.

Some basic justifications for IFI involvement seem to be the same everywhere. They are based upon changing the risk structure of projects for stakeholders. However, the contribution of the IFI becomes increasingly subjective and hard to quantify as lending shifts to the private sector and there is greater financial and economic integration.

In this paper we scan the logic for IFI intervention in a range of situations. The good news is that there do seem to be situations where IFIs will be able to generate value-added for some considerable time. In the most basic case, there will continue to be a role for multilateral wholesalers of funds between states. The bad news is that a globalised economy and the growing emphasis on the private sector as the vehicle for economic development will necessarily increase the competition between IFIs and commercial financial institutions. IFIs may find it difficult to carve out a niche in this evolving economic environment, and this need not be the same for all institutions.

We start the debate with a look at the traditional framework for IFI operations.

The views expressed here are those of the authors, and do not necessarily reflect those of the EIB. Thanks are due to Mireille Fischbach, Ole Rummel and Thomas Schröder for their assistance.

1) The 1990s have seen a number of hostile views on IFIs. For example, the Bretton Woods institutions have been highly criticised by a number of outsiders, including members of the non-governmental organisation (NGO) community, under the banner: "Fifty years is enough".

2. The traditional model

A preferred creditor with sovereign borrowers

The special feature of IFIs is their multilateral nature, meaning that default would have repercussions on all other shareholders.

What distinguishes international financial institutions from other financial institutions (2)? Perhaps the most obvious difference is that their shareholders are governments and that their Articles of Association are international treaties between sovereign states. This feature of IFIs makes them a very special intermediary for capital flows from savers in wealthier countries to investors in poorer ones.

If we start with the model of the World Bank (the oldest IFI, founded in 1944), the intention is that borrowers should be either governments or parastatal agencies that operate under government tutelage. Indeed, the requirement that borrowers obtain a government guarantee is included in the World Bank's Statutes. Thus, the traditional model of the IFI is one of raising funds on international capital markets and lending to governments (3).

The AAA credit rating for the World Bank, and its ability to borrow on the very best terms, comes from its financial strength. The total outstanding loan book can be no more than its subscribed capital plus reserves, so even in the extreme case of every borrower defaulting with no recovery of principal, the entire loss would be absorbed by shareholders - and creditors would be unaffected. Only a very small proportion (a few percent) of IFIs' subscribed capital is actually paid-in as cash. The rest is callable by the institutions in the event it is needed. This callable capital is a guarantee of IFI operations by the shareholders. The approach is essentially the same for most other IFIs (4).

Why should wealthy nations enter into this arrangement when they could just as well guarantee commercial lenders based in their own countries? Indeed, such guarantee schemes often exist for export credits and the like.

The special feature of IFIs is their multilateral nature, meaning that default would have repercussions on all other shareholders. This is a much more powerful deterrent than possible bilateral problems between a particular borrower and lender. The result is that borrowers default against an IFI in only the most extreme circumstances. This is illustrated in Table 1. The comparison between institutions is complicated by the fact that some also lend to the private sector and so they are also exposed to commercial risks. Indeed, the IFC lends only to the private sector. However, if we put the African Development Bank (AfDB) to one side, the general observation is that cases of sovereign default against IFIs are few.

2) We use the term IFIs to mean the African Development Bank (AfDB), the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), the Inter-American Development Bank (IDB), the International Bank for Reconstruction and Development or, more commonly, the World Bank (IBRD), the International Finance Corporation (IFC) and the Nordic Investment Bank (NIB). Some summary statistics on these institutions are shown in the annex.

3) Some private companies did receive government guarantees in the early years of the World Bank - but this practice soon came to an end.

4) One could note some specific features of the EIB and the NIB. These two institutions can lend no more than 250 percent of their subscribed capital, so that the percentage of loans guaranteed by callable capital may drop to only 40 percent (1/2.5). However, they usually only lend outside their members (all at least BBB grade countries) when they receive a guarantee by some third party (e.g., by an individual member country or by a separate multilateral fund). The result is that all loans are of investment grade rating or higher.

Table 1. Non-accrual loans as a percentage of disbursed loans, 1996

ADB	AfDB	EBRD	EIB	IBRD	IDB	IFC	NIB
0.1	10.1	0.3	0.4	2.2	0.0	4.9	0.3

Source: Standard & Poor's.

The key point is that the international framework has created a preferred creditor that cannot be credibly duplicated by private sector lenders. The Paris Club of official creditors can be seen as a way of trying to put debt problems into a multilateral context once they have occurred. However, setting lending in a formal multilateral framework before loan contracts are signed is obviously a much more transparent and robust solution.

All this means that the cost of a state providing callable capital to an IFI is very low, since the likelihood that it will ever be called (the guarantee exercised) is small. It also means that there is a good reason why IFIs can price their sovereign loans on a non-discriminatory, cost-plus basis. While the market must consider individual sovereign risks, these do not exist in the same way for the IFI.

This also explains why debt relief, if funded by the IFIs themselves, must be approached with extreme caution. Such debt forgiveness schemes amount to default in all but name. To agree to debt write-off could undermine the preferred creditor framework unless there are the most carefully defined and controlled conditions (5). This may seem an easy way out for IFIs, and it is particularly galling for some observers who accuse IFIs of contributing to current difficulties through irresponsible lending practices in the past. However, someone must pay the costs of sovereign defaults. If this were to become a common phenomenon, IFIs would have no choice but to charge a risk premium or to stop this type of lending. In either case, the traditional model collapses.

3. The traditional model on a global capital market

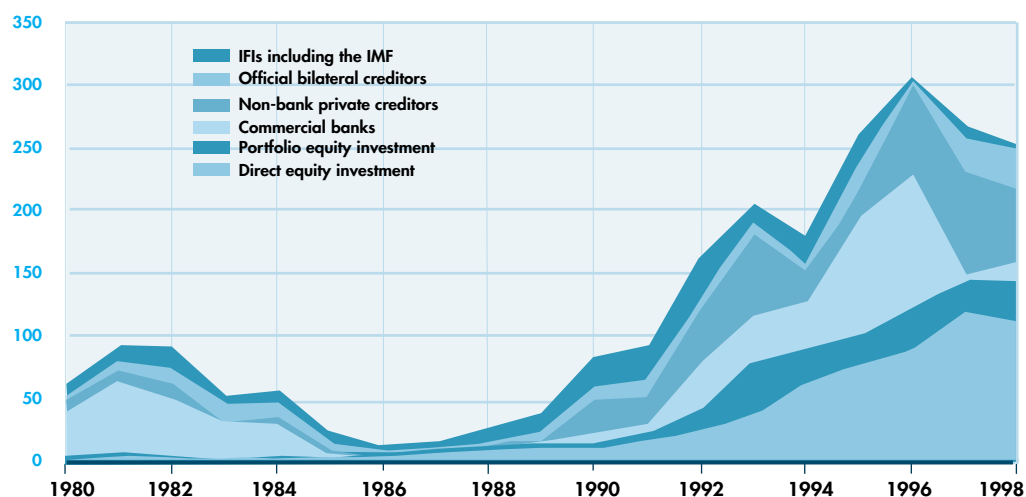
Rewarding inefficiency?

With the exception of the EBRD, IFIs were created when there were controls on international capital flows and private finance for less-developed countries was limited. Indeed, in some ways IFIs could simply be seen as institutions created by governments to circumvent, in a controlled way, the regulations and restrictions they had themselves imposed.

One remarkable feature of the last decade has been the globalisation of international capital markets. This is illustrated in Figure 1. An initial surge in private capital flows to emerging markets, largely associated with the recycling of oil revenues, occurred in the early 1980s. However, these flows (mainly syndicated bank loans) were brought to an abrupt halt by the Debt Crisis of 1982.

5) The AfDB is the only IFI to have been downgraded to an AA credit rating. This was due to a combination of a highly politicised corporate governance, generally weaker shareholders (only one-third of callable share capital was held by investment grade countries) and the reduced number of regional members eligible for new loans. In other words, the credibility of the preferred creditor status and of shareholder support also depends upon how the institutions are run.

Figure 1. Capital flows to emerging markets, 1980-1998 (in USD billion)



Source: International Institute of Finance.

After a period of debt workouts and macroeconomic stabilisation, private capital flows boomed at the start of the 1990s. During this decade, foreign direct investment, portfolio investment and non-bank creditors have been the main source of funds for the developing world.

It is hard to see over the long run what market imperfections could exist that IFIs can eliminate by their mere presence.

By 1996, net lending from IFIs had dropped to only a few percent of total capital flows, down from over 40 percent in 1986 (a peak year for IFIs). As with the Debt Crisis before it, last year's Asian Crisis has led to a severe reduction in net bank lending. Importantly, other sources of private sector finance appear to have been much less affected.

Thus, the middle age of IFIs has been associated with a rapid slide in their overall importance. However, this is not equally true for all countries and the overall picture presented in Figure 1 is highly influenced by a few emerging markets. The fact that IFIs are preferred creditors, and can lend at below market rates, continues to exist even in an environment of global capital markets. Perhaps perversely, the largest financial gains (i.e., the largest difference with the market) occur in countries where sovereign risks are highest.

If there are no obvious failures of international capital markets, then sovereign risk premiums correctly reflect the uncertainties of lending to a particular country. This uncertainty in turn reflects the quality of economic management. The risk that governments will not be able to service debt denominated in foreign currencies would be very small if macroeconomic stability were pursued through appropriate monetary and fiscal policies, and capital inflows were wisely invested. Equally, the existence of sound democratic institutions would reduce the chances of political instability. It is true that only relatively short maturities may be available from private lenders, but this is a rational response to risk. Rolling over short-term credit is quite common in the corporate world as well. It allows a monitoring of the situation that is simply not possible with longer-term maturities.

There is, of course, a period when credibility must be gained by a state. However, it is hard to see over the long run what market imperfections could exist that IFIs can eliminate by their mere presence. In this case, IFIs could be accused of doing nothing more than releasing policy makers in recipient countries from the basically correct discipline of the market place. Under the worst scenario, this could allow greater military spending than would otherwise be the case - with obvious repercussions for peace and stability.

Defining the use of funds and loan conditionality

One answer to the above question is that IFI lending is tied to a particular project (though this may be a 'policy' project as well as a physical investment) rather than just providing credit lines as a private lender might. This ensures that funds are used in a clearly specified, and hopefully sound, manner. The role of the IFI can range from simply checking project dossiers to offering technical assistance for project design and implementation.

Having cheaper finance available from IFIs distorts public investment towards those projects and sectors where this finance is available (5). Moreover, part of the policy package that comes with an IFI loan is likely to change the nature of the investment in a way that also benefits residents of other countries. This occurs even at a very focused project level, for example, through requiring competitive international tendering for suppliers and recognition of certain minimum environmental standards.

There is a trade-off between expanding lending to broader and broader programmes, and the assurance that this is not simply providing credit lines to governments.

The selection of projects is not without problems, however. IFIs are wholesalers of funds and they lack retail outlets. This means that they can only study relatively large investments. The task of originating smaller loans is prohibitively expensive. While some very large projects do have high economic returns, there may be investments at a small-scale that actually contribute more to economic development. The end result is that IFIs can distort investment towards excessively large, capital intensive, projects. One solution is to fund broad sectoral programmes, and many IFIs have supported this type of loan. The problem, as pointed out by some non-governmental organisations (NGOs), is that the staff of IFIs cannot have the local knowledge needed for the successful implementation of small community-based projects. This also applies to building institutional capabilities in recipient countries, an activity that requires close contact between trainers and trainees.

In funding these activities, IFIs must largely delegate project design and management to local counterparties or consultants. The final investment will only be as good as these counterparties. Thus, there is a trade-off between expanding lending to broader and broader programmes, and the assurance that this is not simply providing credit lines to governments.

If the IFI has no impact on the quality of investment, and hence on economic growth, the effect of its lending could be pernicious. Since the overall riskiness of the government would not change, one consequence of creating a preferred creditor would simply be that other loans from commercial lenders would get more risky.

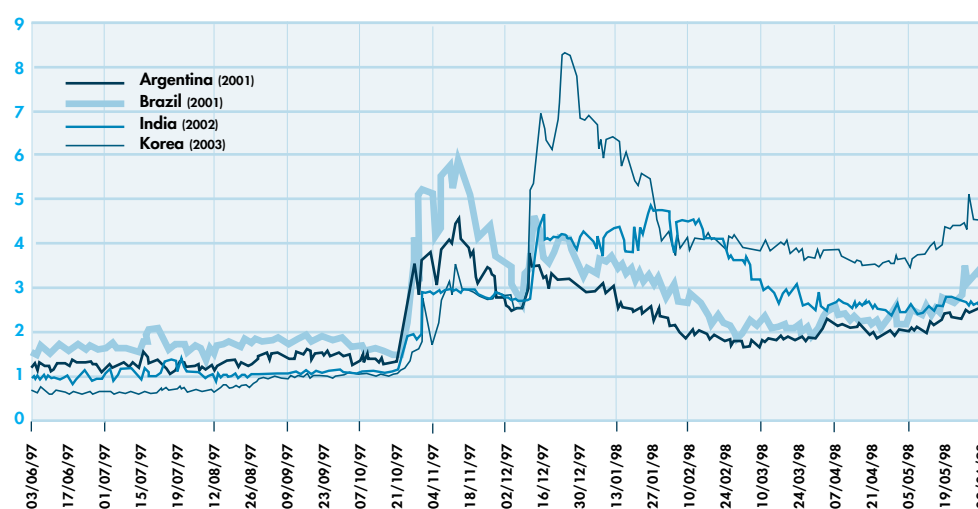
5) It must be recognised that leakage of funds to non-productive activities remains possible, since some components of the IFI-defined projects may still have been done even if an IFI loan had not been forthcoming.

4. Instability, over-reaction and IFIs

Herd instincts and volatility

While the globalisation of finance should reduce market imperfections, a 'herd' tendency in international financial markets can still lead to volatile capital flows. Financial markets did a very poor job of anticipating the last two major crises - in Mexico in 1994 and last year in Asia. In these cases, lax foreign lending helped to support inefficient management (whether of government spending in the case of Mexico, or of risk control by banks in Asia). When the correction finally came a severe change was needed. With such dramatic swings in market sentiment, an over-shooting in the correction becomes likely.

Figure 2. Eurobond spreads, June 1997-June 1998 (in percent)



Note: The figure shows the spreads of USD-denominated eurobonds of Argentina, Brazil, India and Korea relative to US Treasury bonds with the same maturity.

Source: Datastream.

A further consequence of a herd mentality is that countries can be damaged by bad news from an unrelated economy. As an illustration, Figure 2 shows the large, but temporary, jump in government bond yields in a number of countries after the Asian crisis.

International crisis management

Information on macroeconomic conditions is collected and analysed by independent rating agencies. Since this information also has its imperfections, the IMF's view on economic policies has become an important signal for future prospects. Some IFIs may also participate with the IMF in macroeconomic stabilisation packages. In Figure 1, the large increase of IFI and IMF lending in 1997 is due to the very substantial assistance provided to Asian economies after the crisis in October of that year.

If the IMF lacks sufficient resources to put emergency lines of credit in place, then there may be short-term gains from sharing the burden with other IFIs (typically the World Bank and the relevant

regional IFI). However, this 'fire-fighting' is a fundamentally different business from the long-term development-financing model we have discussed.

The traditional role of IFIs can continue for some time. However, the risk of being left behind by the wayside of a rapidly globalising capital market may seem very high.

In this case, IMF macroeconomic conditionality is the cornerstone of ensuring the funds are used for appropriate reform measures rather than simply bailing out inefficient governments (and hence, indirectly, other lenders). There could also be a case for IFI participation if the stabilisation package requires a number of longer-term structural measures, such as reform of the banking sector. However, it must be recognised that the time needed to prepare a sectoral loan may be very different from that available when international liquidity problems arise. Certainly, using IFI balance sheets as a conduit of funds because the IMF has funding problems is not a suitable role over the longer term.

Resource allocation under uncertainty

The key issue for IFIs is that the risk of temporary shocks to interest rates could have a significant effect on the decision to implement capital intensive projects. At the government level, increased volatility in interest rates will lower the optimal level of external debt and so the availability of foreign currency to fund public investments. At the project level, the cash flow of capital intensive investments can be particularly sensitive to interest rate developments. This is a serious issue for project promoters facing liquidity constraints. Though most pertinent to the private sector (a subject discussed later in the paper), a number of parastatal agencies may also be expected to operate as autonomous financial entities and so face similar concerns (7). The ability of IFIs to put sovereign risks to one side and to take a long-term view of a project's viability can thus help ensure that key projects are actually implemented. The issue is not only one of international liquidity, but also concerns resource allocation in the face of uncertainty.

A general conclusion at this point is that, *since it does not depend upon any market imperfection*, the traditional role of IFIs in supporting public investment can continue for some considerable time. As economic growth and stability reduces spreads on sovereign debt, the financial benefits of IFI lending shrinks. However, IFIs can be a cheaper source of funding than international capital markets even for highly rated governments. With economic development, project selection can be increasingly delegated to national authorities. The obligation of IFIs to ensure that funds are only used for sound purposes remains, however.

One problem, at least for IFIs, is that this traditional core activity restricts their contribution to the development agenda to that of designing, building and managing public infrastructure. And even in this area IFIs are likely to be excluded from a number of new institutional structures involving the private sector. The risk of being left by the wayside of a rapidly globalising capital market may seem very high.

5. The risk structure of private sector projects

The rise of the private sector borrower

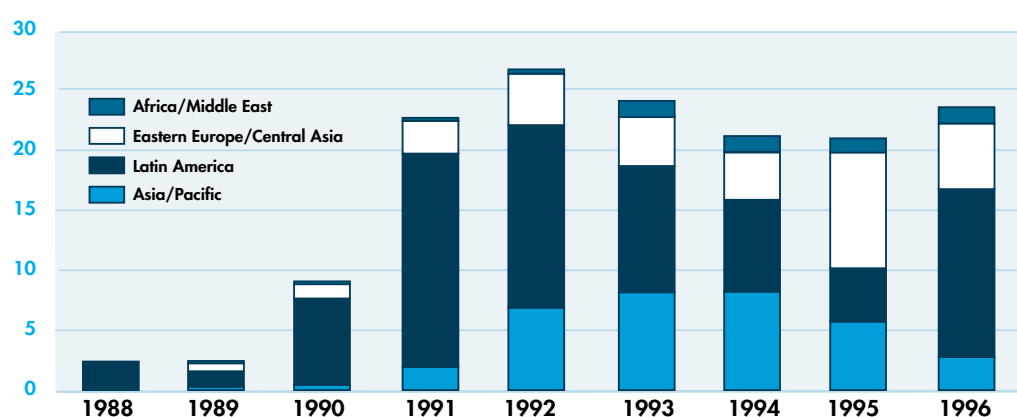
One feature of the last decade has been the recognition that many activities previously considered as the natural domain of the state can be readily, and perhaps more efficiently, provided by the pri-

7) Of course, such agencies are not fully autonomous since they benefit from government guarantees and often receive subsidies in one form or another.

vate sector. In addition, it is natural in today's environment of fiscal rectitude that governments should look increasingly to the sale of state enterprises to improve public debt levels. Figure 3 shows the jump in privatisation revenues in developing countries between the late 1980s and the 1990s, rising to an annual average of about USD 22 billion. Infrastructure accounts for more than 40 per cent of the total.

This trend also includes the close involvement of the private sector in the development of new infrastructure through public-private partnerships (PPPs). Such investment has averaged some USD 60 billion annually worldwide in the last decade, and is growing at a rapid pace.

Figure 3. Privatisation revenues in developing countries, 1988-1996 (in USD billion)



Source: World Bank.

While this emphasis on the private sector in the development process has emerged recently, the potential for IFI lending to the private sector was recognised long ago. The International Finance Corporation (IFC), the World Bank affiliate specialised in private sector operations, was set up as early as 1956. Other IFIs have also started private sector lending, though this is still very small for those IFIs most wedded to the traditional model (7).

Sovereign risks

One dimension of the preferred creditor model outlined above still holds. Unless a company is producing offshore revenues that can be used to secure borrowings, the credit rating of all private sector entities is capped by that of the host state. The rationale is that no company can be in stronger position than its own government to convert domestic currency into foreign exchange in a timely fashion. This means that even if there are investments that are inherently better than the state, this cannot be reflected in the credit rating of private sector promoters.

7) For example, private sector lending by the ADB and IDB is only a few percent of turnover. The current policy guidelines are that private sector operations should be no more than five percent of annual lending at the IDB, two to three percent of portfolio at the AfDB and five to six percent at the ADB. The EBRD is in a particular position since its Statutes require that it do a minimum of 60 percent of turnover with the private sector. One of the most rapid transitions to the private sector has taken place with the EIB. Over the last decade EIB loans within the EU guaranteed by the public sector have dropped from some 80 percent of the total to under one-half.

The IFI can still ignore these sovereign risks since the host state would not limit access by project promoters to the foreign currency needed to service their debt. Equally, the project promoter would not be exposed to other political risks such as expropriation. This is most evident with the so-called 'B' loan of the IFC. When the IFC prepares a project, the planned loan may be split into an 'A' component and a 'B' component. The A loan is a normal loan from the IFC, while the B loan is refinanced with a syndicate of commercial banks. Normally, there is a single loan agreement between the IFC and the borrower for the full amount of the finance to be provided. The IFC then signs individual agreements with participating banks. Since the commercial bank syndicate comes under the IFC 'umbrella', the regulatory authorities of many countries have exempted IFC loan participation from country-risk provisioning. The IFC charges a fee for acting as lender of record and loan administrator, though this is much less than the level a normal valuation of sovereign risk would imply.

The only solution is for IFIs to be managed so that there is a negligible probability of requiring callable capital.

Along the same lines, a number of IFIs now offer sovereign risk insurance. For example, the World Bank - prohibited from lending directly to the private sector - has developed a programme of political risk coverage for loans from commercial banks. The Multilateral Investment Guarantee Agency (MIGA), another member of the World Bank Group, offers a similar service (9).

Commercial risks and regulatory risks

However, lending to the private sector exposes IFIs to commercial risks and, unlike sovereign risks, these cannot be evaded. Indeed, in recognition of the different nature of this business, both the EBRD and IFC offer a range of equity-related products as well as loans.

When IFIs take commercial risks on their books, the logic for the original capital structure disappears. The IFC offers a clear example of this. While the IFC Statutes still define its maximum gearing (at up to four times its subscribed capital and reserves), in practice its approach is based on different principles. To start with, nearly all its subscribed capital is paid-in. This illustrates that when commercial risks are sufficiently large, it becomes impossible to maintain the concept of guaranteeing operations with callable capital that in principle will never be called. Of course, shareholders could assume commercial risks and let their callable capital be exposed to defaults, but it is not clear why they would ever wish to do this. Moreover, it would lay government budgets open to potentially large shocks, with the risk of severe disruption to national spending/borrowing plans.

What does this imply for institutions that have just a small share of subscribed capital that is paid-in? It would appear that the only solution is for these IFIs to be managed so that there is a negligible probability of requiring callable capital. Hence, the appropriate level of *paid-in capital and reserves* should be approached in much the same way that a private financial institution would look at the problem; i.e., to ensure that there are sufficient funds to absorb all risks of default at some relevant confidence level (10). In line with this, the IFC has adopted the rule that its capital base should be at least 30 percent of risk-weighted assets.

9) By late 1997, the World Bank had provided such guarantees for a total of USD 1 billion of loans. At the end of the last fiscal year (June 1997) the maximum contingent liabilities of MIGA had reached USD 2.5 billion.

10) That is not to say that the targets for IFIs should be similar to commercial banks, since there may be very many specific issues. Rather it means that the technical approach to the problem would be similar.

The IFC was set up to deal *exclusively* with the private sector and its situation is unique among the IFIs (11). Nevertheless, most IFIs are keen to expand their operations with the private sector, and the issue of their adequate capitalisation (i.e., of paid-in capital plus reserves) will have to be addressed.

There are different ways to adjust to the changed circumstances. On the one hand, the IFI could outsource the bulk of commercial risk to other parties. This is what the EIB has done by requesting third-party guarantees on its private-sector lending. While this approach has worked in the European Union, where the local financial market is sufficiently developed and robust financial institutions are ready to assume the commercial risk, it is not obvious that such an approach can be easily replicated everywhere. On the other hand, a clear separation of sovereign and commercial risk could be obtained by transferring the latter to a dedicated affiliate dealing exclusively with the private sector (as with the World Bank - IFC model) (12). The capitalisation of the IFI affiliate would then be structured to fully cover commercial risks. However, it is not certain whether, in such a set-up, the privileged creditor statute of the traditional IFI can always be credibly transferred to the private sector arm.

The thorny issues of how individual loans are managed and priced will also have to be looked at. In a similar vein to the discussion of callable capital, it is unclear why IFIs' shareholders should allow their paid-in capital to bear commercial risks free of charge (13). If these risks cannot be transferred to third parties, they should be priced so as to maintain the IFI's return at the equivalent risk-free level. Obviously, in the case of structured finance there can be a complex combination of risk taking and risk mitigation, with some risks being carried on the bank's books and others being covered through credit enhancement schemes.

When regulatory regimes are immature, an IFI involvement in a project may give comfort to other investors that regulatory decisions will be fair.

Most IFIs do not have a large pool of expertise in the management of commercial risk, and there is little reason for these institutions to enjoy any comparative advantage in understanding these risks with respect to international commercial banks. However, IFIs can still play a very specific role in private sector projects. For example, one feature of the recent trend to privatisation and the emergence of private sector financed infrastructure has been the growth of regulated private monopolies and other public-private partnerships. When regulatory regimes are immature, there may be some doubt by investors over the way in which regulations will be interpreted in the future. If an IFI is involved in a project, this may give considerable comfort to other investors that regulatory decisions taken in the future will be fair and based upon sound criteria. While a more qualitative factor than the traditional preferred creditor status, the IFI presence still implies a different set of relationships with the state than may otherwise be the case.

In a similar spirit, many private infrastructure projects are capital intensive and have long payback periods. As IFIs have little difficulty to raise funds at competitive terms for long maturities, their intervention may serve as an important catalyst to get the project going (as discussed before, the avail-

11) The IFC is also unique in that it has a long history of private sector activity and thus much better data on the default risks associated with its business.

12) The Inter-American Investment Corporation provides another example.

13) Some may think that there are positive externalities for shareholders from IFIs' private sector lending, and that this would militate in favour of them bearing part of the commercial risk. However, this is far from evident. As discussed later in the paper, the target return on equity of IFIs' shareholders is basically equal to the cost of their public debt. Any externality may already be captured in the gap between the return on equity generated by IFIs and that which private shareholders would normally require.

ability of long-term debt can have a major effect on the cash flow of such projects). The magnitude of these benefits is clearly a highly subjective matter, however.

6. A new role in the development of regional capital markets?

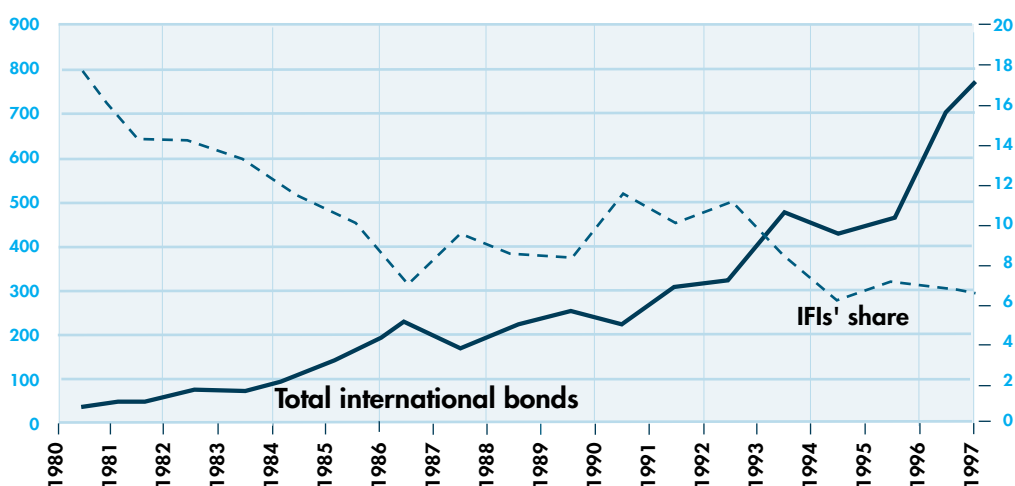
The widening scope of IFI borrowing activity

Within a global movement toward freer capital flows, IFIs have widened the set of currencies in which they borrow.

It has recently been recognised that building sound domestic financial and banking markets is also a key factor in the development process. Numerous studies have demonstrated that financial development goes hand in hand with economic development. This means that the capital market and treasury operations of IFIs may play a development role if their action leads to the transfer of know-how to local financial institutions.

As shown in Figure 4, the (gross) volume of funds raised by IFIs on the international bond market is large, both in absolute value and in relative terms. Naturally, the sharp development of the international bond market since 1990 has meant that the relative market share of IFIs has trended downwards. By the mid-1990s, the annual borrowings of IFIs amounted to about USD 50 billion, or seven percent of the international bond market.

Figure 4. Size of the international bond market (in USD billion) and IFIs' market share (in percent), 1980-1997



Source: OECD Financial Statistics.

Within a global movement towards freer capital flows, and growing investors' appetite for investment in less traditional currencies, IFIs have widened the set of currencies in which they borrow. This is illustrated in Table 2. Does this trend to borrowing in emerging market currencies provide IFIs with a new development role, and so a new 'raison d'être' for the coming years?

A first observation is that the mere borrowing by an IFI in a particular currency does not automatically translate into a transfer of know-how to that country. The IFIs lending mainly to the public sector have little genuine demand for loans in other than the major international currencies. This is because governments are usually AAA-rated in their own currencies. Even if central banks are inde-

pendent, so governments cannot simply print money to service their debt, they usually still have sufficiently strong tax raising powers that the risk of the government coffers being empty is negligible.

As the bulk of borrowings in non-traditional currencies adopt the euro-market format, the IFIs' contribution to the development of financial markets is likely to be modest.

In these cases, borrowings in new currencies are usually exchanged *via* a swap with non-resident investors. International investors may find that the securities issued by IFIs in emerging market currencies are attractive, since there are no credit risks. Such investors are comfortable with bearing the interest rate and exchange rate risks involved, but do not wish to be concerned by the condition of the domestic financial market. Indeed, the bulk of borrowings in non-traditional currencies adopt the euro-market format. This eliminates a host of possible complications. The backbone infrastructure of the euro-market for listing, trading and clearing and settlement can be used, and most legal difficulties are also avoided. In such a context, the main result of IFIs' borrowings is the internationalisation of the currency. The contribution to the development of financial markets in the country of origin is likely to be very modest.

Table 2. IFIs' market share of international and eurobond issues, 1988-1998 (in percent)

Currency	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998*
Spanish pesetas	77	48	74	63	55	50	50	52	47	47	38
Portuguese escudos	100	0	69	77	86	65	52	32	18	18	9
Greek drachmas	—	—	—	—	—	—	69	100	100	35	60
Hungarian forints	—	—	—	—	—	—	—	—	—	—	100
Czech koruna	—	—	—	—	—	—	0	62	43	23	33
Polish zloty	—	—	—	—	—	—	—	—	50	68	70
South African rands	—	—	—	—	—	—	—	7	33	59	59
Korean won	—	—	—	—	—	—	—	100	—	100	—

*First five months of 1998

Source: IFR Securities Data.

Irrespective of their final currency needs, it remains true that IFIs have usually been the first borrowers to open bond markets in the less traditional currencies. One reason may be that they have had an explicit privileged access to a market (because authorities do not permit other issuers to tap the market), or implicit advantages as their status and name recognition has allowed a clear separation of credit risk from other sources of financial risk. These arbitrage opportunities, together with the preferences of the day of international investors, are the driving forces for the bulk of IFI funding operations in non-traditional currencies. Nonetheless, there are still very good reasons for IFIs to broaden their base of funding currencies in this way. These operations provide attractive conditions, which in turn lead to cheaper lending rates through the usual cost-plus pricing approach.

Intermediation within regional markets

The story may be different for those IFIs which are more involved with the private sector, as they do face a natural demand for the domestic currency in question. Private sector borrowers are much less interested than sovereign borrowers in obtaining foreign currency loans unless it is good financial logic to do so. For example, the EIB has a stable demand for loans in non-traditional currencies, and it has had a vested interest in promoting and developing the domestic capital markets of less-advanced European countries. Such an approach does not necessarily provide the same short-term gains as the opportunistic deals mentioned above, as it requires a sustained effort to build up local skills. Some IFC operations provide another approach to fostering the development of local capital markets, by sponsoring the issue of domestic securities by resident issuers (14).

We can conclude that certain types of IFI operations, though only a small share of the current total, can have a beneficial impact. Once more, lending to the private sector appears to be the point of departure for any new role. However, this 'raison d'être' is likely to be ephemeral. Even if IFIs succeed in fostering the development of local capital markets in the early stages, their leading role is bound to be transitory - and much more so than the 'graduation' that will occur on the lending side.

7. Competition with commercial financial institutions

This issue of whether an EU institution should be involved in a particular facet of public policy goes under the title of 'subsidiarity'. It has its parallels in the broader debate of 'additionality' and 'complementarity' for IFIs in general. The term subsidiarity was in fact first used by Pope Pius XII in 1931 when talking of the Catholic Church, and the debate over the role of IFIs also often has a strong ideological fervour.

Unfair advantages?

When IFIs lend to private sector borrowers, and start to offer a range of associated financial services, the scope for competition with commercial banks becomes very apparent. Aside from the benefits that arise from the inter-governmental framework addressed before, IFIs have a number of other advantages including exemptions from taxation. They may also have an advantage due to their high capitalisation and the relatively low returns required by their shareholders.

Of course, the capital actually paid in to IFIs does have a cost. If these institutions were closed down and capital paid back to shareholders, then government debt could be reduced by an equivalent amount. At the same time, being non-profit seeking does not mean that there is no return on shareholders' equity. The usual approach is for an IFI to price its loans as though they were 100 percent financed through borrowing. Since there is also equity on the liability side of the balance

When IFIs lend to private sector borrowers, and start to offer a range of associated financial services, the scope for competition with commercial banks becomes apparent.

14) One further feature of intermediation on regional capital markets (between domestic investors and domestic project promoters) is that the ability of the IFI at assessing project risks may be better than that of local banks, particularly for complex structured finance. This means that the advisory skills of the IFI may continue to be helpful, even when they bring little additional knowledge to the international financial market place (assuming, of course, that the local subsidiaries of multinational commercial banks are not already well established). However, taking a very large share of the financing plan of any particular project could be counter-productive since it would crowd-out local financial companies.

sheet, this implicitly prices equity at the same rate as the institutions borrowing costs. Thus, the return on equity is related to government benchmark interest rates (15).

However, this return is less than the profitability the shareholders of private banks would be looking for. Some comparisons of IFI returns and those of some large banks are illustrated in Table 3. Obviously, there may be considerable volatility to the figures, and the benchmark return depends upon the currencies in which assets are denominated. Moreover, the figures are not comparable, since the product mix may be quite different for the various institutions shown, but the overall picture is one of relatively cheap equity for IFIs (16).

Table 3. Real return on equity, 1992-1996 (in percent)

	ADB	AfDB	EBRD	EIB	IBRD	IDB	IFC	NIB
1992	4.9	3.4	-4.7	3.6	1.7	2.6	2.4	4.4
1993	5.2	1.3	-3.8	4.4	1.7	2.8	5.5	8.1
1994	4.1	0.6	-3.2	3.5	2.5	2.3	3.1	8.4
1995	4.9	0.8	2.7	4.3	2.0	3.3	5.8	8.8
1996	3.4	1.7	-2.4	3.5	2.3	1.3	6.2	8.3
Average 1992-1996	4.5	1.6	-3.3	3.8	2.1	2.5	4.6	7.6

	Deutsche Bank	Société Générale	Lloyds Bank	Istituto Mobiliare Italiano	Rabobank Nederland	Crédit Local de France	ING Bank	Abbey National
1992	14.6	9.4	22.2	5.7	7.9	12.5	10.5	12.4
1993	18.1	8.7	27.4	8.7	9.3	12.5	12.9	16.7
1994	12.6	7.8	30.7	7.1	8.9	14.0	11.6	22.1
1995	12.6	10.3	39.3	5.1	10.6	11.0	13.7	22.8
1996	14.7	10.9	46.4	8.3	9.8	13.3	12.4	23.5
Average 1992-1996	14.5	9.4	33.2	7.0	9.3	12.6	12.2	19.5

Notes: Equity is defined as paid-in capital plus reserves for IFIs. The return for the private sector is calculated after provisions, but before taxes. All the private sector banks are AA rated or better. While shareholders' equity is exposed to more risk than that of an IFI shareholder, these remain sound financial institutions. The EBRD is in a specific position as it has just started operation. Its operating costs are yet to be covered by margin income from disbursed loans.

Source: Bankscope.

15) The actual return earned depends upon the maturity composition of assets and liabilities, whether there are losses, and the extent to which administrative costs are covered through an additional mark-up.

16) The pressure on private institutions to get the most from their capital is clearly illustrated by the growth of securitisation, as banks package and sell low-earning loans to the market to free capital for more profitable purposes. This has become very widespread in the US, and is also growing rapidly in Europe. Worldwide, the market for asset-backed securities is of the order of USD 500 billion per year.

IFI displacement of private sector lenders may be justifiable, if the cheaper finance causes economic activity to adapt in line with public policy objectives.

If IFIs are cheaper than other sources of finance, it is normal that private sector investors would turn first to the IFI for finance. This is different from lending to governments. For the public sector, the overall package of project definition and loan conditionality clearly differentiates the IFI product from the lines of credit provided by private sector lenders. Project appraisal is obviously also needed with private sector borrowers, but commercial banks would often have to do a similar analysis to assess risks. Indeed, if the investment is made by private sector promoters in sectors that are competitive, and where there are no subsidies or other economic distortions, assessing the financial profitability of a project is essentially the same task as estimating the economic rate of return. Sound banking and development banking are one and the same (17).

The result of the possible competition between IFIs and commercial banks will be some crowding-out of private banks unless the IFI's involvement increases the demand for finance by an amount equal to its own lending. Except for the IFC B loan structure, or other guarantee schemes, it is likely that crowding-out will always happen to some degree.

IFIs as an instrument of public policy

Even if the IFI does displace private sector lenders, this is still justifiable if the cheaper finance causes economic activity to adapt in line with public policy objectives.

One public policy goal could be to provide re-distributive transfers. An analogy can be drawn with government subsidies used within developed countries to relocate investment to lagging regions. Debt may be a better instrument than straightforward grant at achieving this goal, though not all of the problems associated with grant may be resolved. As with transfers, there may be substantial dead-weight losses (the projects would have been done anyway without the subsidy element) and the windfall profits from a cheap IFI loan may still encourage inefficiency by the recipients. Nonetheless, the obligation to repay debt is perhaps the best way of ensuring appropriate 'ownership' of the projects that are financed, and that funds are used for profitable purposes in a well-managed way. Of course, loans and grant can also be packaged together, and many IFIs are already involved in interest subsidy schemes with the subsidy element funded by aid donors (e.g., the International Development Association of the World Bank Group).

Public policy goals may also include measures to compensate for market failures in the real economy. Recent theories in economic geography have emphasised that growth may be concentrated in economic agglomerations (due to 'technical spillovers', concentrated labour markets, etc.). It is to offset the possibly widening gap between the most and the least advanced regions that public intervention may be required.

Such logic is perhaps most pertinent for IFIs that operate within relatively well integrated economic zones. At the international level, the environmental sector may provide a clearer example. Pollution does not respect national barriers, and there may be a global dimension to some environmental problems. Ideally, government regulation would mean that environmental costs are covered by

17) There is one group of loans where the IFI could take a different view from a commercial lender - loans to banks for on-lending to small and medium-sized enterprises. A commercial lender would only be interested in the creditworthiness of the banking intermediary, while the IFI may also be concerned about the rules used to allocate loans to final beneficiaries. This is another of the ways in which IFIs can contribute to local financial sector development.

polluters (i.e., the 'polluter-pays-principle'), though this may not always be possible. In any case, there is a logic that subsidies should be used to help poorer countries to reach the minimum standards desired by wealthier countries since their own preferences could be to accept higher pollution levels. Each IFI has its own public policy goals that would justify action along these lines.

Two extreme views on IFI lending to the private sector

While the displacement of commercial banks could be justified by these public policy considerations, the problem is that the 'value-added' of the IFI becomes progressively more subjective in these new settings, and the trade-off between the volume of activity and value-added becomes highly judgmental.

One could foresee two opposing views:

- IFIs should be given the benefit of the doubt, since added value is essentially non-quantifiable. Moreover, commercial banks offer a range of products while the IFI may focus on one or two key products (such as 'plain vanilla' long-term loans). Competition will only occur in a small market segment, and in a segment that it is not particularly profitable for commercial banks.
- The market should be relied upon to the maximum extent. IFIs should only intervene when there is no doubt over complementarity. This would mean developing the kinds of intervention that support the commercial banking sector. Examples would be guarantee schemes, B loans in appropriate settings, support in loan syndications, etc.

There is an important argument to support the first view. **When IFIs are operating efficiently**, there is no welfare loss if the public sector (e.g., an IFI) funds a project instead of a commercial bank. It is simply a question of commercial banks searching market share, and this is not in itself a goal for policy makers to be unduly concerned about (18). However, if the IFI cannot demonstrate that it adds value (e.g., through advancing investment, or changing investment patterns in a desirable way), and it becomes almost indistinguishable from other banks, it is legitimate for shareholders to ask: why bother?

Where a particular IFI ends up, will depend upon local factors and the consensus between shareholders on the role of public banks in general.

The second, more minimalist view, does not necessarily solve the problem of additionality in a clear-cut way. Indeed, with the growth of capital markets and securitisation of bank assets, it is exactly in the advisory sphere that some banks are looking for future profits. For example, a group of major banks (meeting under the auspices of the International Institute of Finance) have requested that the IFC should not compete for publicly tendered privatisation mandates, that it should rely to a greater extent on the ability of banks to appraise, arrange and manage project financing, and that it should limit underwriting of international securities to exceptional cases. Taking the logic to the extreme, everything an IFI does with a private sector project, including political risk insurance, can be done

18) However, it would require a generous interpretation of the IFIs' Statutes to arrive at this conclusion. Most include a prohibition to financing investment where funds are available on 'reasonable terms' from other sources (e.g., the AfDB, EBRD, EIB, IDB, IBRD, IFC), though the language is slightly more nuanced for the ADB (it will pay 'due regard' to the availability of alternative finance), and the NIB, set up by Nordic countries in the 1970s, has no such limitation. What is 'reasonable' is, of course, in the eye of the beholder. Taking a legalistic view, it will usually be impossible to document and compare the terms of alternative sources of finance, meaning that the subjective judgement of the IFI must be relied on. Since there would be no demand for IFI finance if it were not less costly than other sources, one could argue that every IFI loan is more 'reasonable' than the market.

by private financial institutions - albeit at a different price. This means that where a particular IFI ends up between the two positions set out above will depend upon local factors and the consensus between shareholders on the role of public banks in general (there is by no means a uniform dogma on this issue). IFIs may evolve in quite different directions as a result.

The key issue: the efficiency of IFIs and how to prove it?

A further factor in deciding the final role for IFIs, and perhaps the determining factor, will be the reputation of the institutions. Are they indeed efficient in reaching their objectives? Or are their privileges and advantages simply supporting inefficient and wasteful bureaucracies?

There will be growing pressure for IFIs to demonstrate their effectiveness.

The bottom line for private companies is their profitability and the return on equity they generate for shareholders. Of course, it is not always straightforward to understand what is happening, and short-term profits can be boosted at the expense of sustained long-term returns. However, assessing performance is much simpler than for IFIs. These institutions are run on cost-plus principles, so the return on equity is determined more by interest rate developments than anything else, and they pursue a complex range of non-quantifiable objectives (19).

An additional complicating factor is the lack of transparency of decision making for groups outside the institutions. The IMF has most recently come under attack for this (20), but the same issue applies to IFIs in general. Though there may well be an unnecessary level of secrecy, it should be recognised that banking confidentiality does make openness difficult, particularly when private sector borrowers are involved.

The end result of these factors is a lack of information on the costs and benefits of IFIs. Aside from overall efficiency, this could also lead to undesired cross-subsidies from one activity to another, a further distortion of the playing field in the IFIs' favour. Such a situation will become increasingly unacceptable, and, as with all public sector activities, there will be growing pressure for IFIs to demonstrate their effectiveness.

This issue also raises an interesting question regarding the capitalisation of IFIs. In purely theoretical terms, there is not necessarily any inefficiency if these institutions have more paid-in capital and reserves than they actually need to support commercial risks. It is simply substituting IFI equity for greater borrowing, or private savings (from the people who buy the IFI bonds) by public savings (from taxpayers) (21).

19) Other public institutions, e.g., hospitals and schools, also face a complex range of objectives. However, it may be relatively easier in some of these sectors to construct quantitative indicators of performance (e.g., waiting times for operations and success rates, and the percentage of pupils attaining certain educational standards).

20) For example, the G7 meeting in May 1998, encouraged the IMF to publish more information about its decision making.

21) Of course, this is not strictly true if raising taxes causes substantial distortions to the economy. To put the figures in some context, the paid-in capital and reserves of the institutions discussed in this paper is equal to some one-third of a percent of OECD GDP.

This theoretical argument does not hold if governments face constraints on gross government debt, since holding illiquid IFI assets does constrain the funds they have available for other purposes. This is certainly the case within the European Union due to the fiscal requirements of EMU, but it probably holds for many other governments as well. Indeed, the fiscal rectitude and move to the private sector mentioned in Section 5 are not restricted to developing countries. This means that it is very likely that one of the ways in which IFIs will be asked to demonstrate their efficiency is by using a minimum of shareholders funds to pursue their goals.

8. Conclusions

In this paper we have looked at the institutional framework for IFIs to see how this may adapt in the next century. The traditional model is of an institution ideally structured to fund large public infrastructure projects (or the state-owned industry that was also common in the post-war period). It is not that this model has lost any of its validity, but rather that the world has changed around it. Lending has shifted towards sectoral and programme finance, and IFIs have progressively delegated project design and implementation to counterparties.

A consequence of significant private sector lending is that commercial logic must increasingly apply to the IFIs themselves.

More fundamental, however, is the shift to the private sector as an agent for development, and the desire for IFIs to participate in this process. While small tentative steps can be taken in this direction with little impact, a consequence of significant private sector lending, and of the inevitable competition with commercial banks, is that commercial logic must increasingly apply to the IFIs themselves - and their accounts may look more and more like those of a private sector bank.

Taking this logic to its extreme and looking further into the future one could imagine that some IFIs will consolidate back to the traditional model, while others will become progressively private sector-oriented.

A middle ground could exist for those institutions that act as agents for grant donors, and package this together with loans. Even in highly developed regions there can remain market failures that justify public sector intervention in this way (perhaps the environment is the most obvious candidate).

For the group that is oriented most strongly towards non-commercial financing of the private sector, it may be a small step to explicitly unbundle sovereign and commercial risks, with sovereign risk insurance being provided by institutions operating along the lines of the traditional model. In this case, the private sector IFI may become a commercial entity in all but name.

This is crystal ball gazing far into the future. On balance, the near-term solution of euthanasia for IFIs seems a far too pessimistic view of their usefulness. However, the next few decades may be very much more aggressive and challenging for these institutions than it was for the first few decades of their existence. To quote the poet Philip Larkin: *"Life is first boredom, then fear"*.

Annex

Some statistics on IFI balance sheets, 1996

AfDB	ADB	EBRD	EIB	IDB	IBRD	IFC	NIB
Maximum gearing							
Loans outstanding, undischursed commitments and guarantees, cannot exceed 100 percent of subscribed capital, reserves and surplus.	Loans outstanding, undischursed commitments, equity investment and guarantees, cannot exceed 100 percent of subscribed capital and reserves.	Loans outstanding, equity investment and guarantees, cannot exceed 100 percent of subscribed capital, reserves and surplus.	Loans outstanding and guarantees cannot exceed 250 percent of subscribed capital.	Loans outstanding and guarantees cannot exceed 100 percent of subscribed capital and the general reserve. <i>In addition, policy to target reserves-to-loans ratio at 20 to 25 percent.</i>	Loans outstanding and guarantees cannot exceed 100 percent of subscribed capital, reserves and surplus. <i>In addition, policy to target reserves-to-loans ratio at 14 percent.</i>	Loans outstanding and guarantees cannot exceed 400 percent of subscribed capital. <i>In addition, policy that paid-in capital and reserves must be at least 30 percent of risk-weighted assets.</i>	The ordinary lending ceiling is set at 250 percent of subscribed capital.
USD billion							
<u>Total balance sheet assets</u>							
13.6	35.3	13.5	170.1	40.6	159.8	18.6	11.0
<u>Disbursed loans</u>							
9.5	16.1	3.8	132.0	25.2	102.6	6.0	7.3
<u>Subscribed capital</u>							
22.1	49.4	12.3	77.7	80.1	180.5	2.4	3.5
<u>Paid-in capital</u>							
2.1	2.7	3.6	5.5	3.0	9.1	2.2	0.4
<u>Reserves</u>							
1.3	6.6	0.0	16.1	6.1	16.3	2.5	0.7
Percentages							
<u>Paid-in capital/Subscribed capital</u>							
9.0	5.3	29.1	7.0	3.7	5.0	94.2	10.8
<u>Disbursed loans/Subscribed capital plus reserves</u>							
39	29	30	141	29	52	122	172
<u>Disbursed loans/AAA callable capital plus paid-in capital and reserves</u>							
123	55	43	202	63	103	126	432
<u>Disbursed loans/Paid-in capital plus reserves</u>							
282	173	103	613	277	403	126	670
<u>Non-accrual loans/disbursed loans</u>							
10.1	0.1	0.3	0.4	0.0	2.2	4.9	0.3
<u>Loans to rescheduling countries/disbursed loans</u>							
44.8	0.0	21.1	1.3	8.1	11.9	7.4	0.2

Notes: The subscribed capital of the EBRD was doubled on April 3, 1997, with the paid-in ratio set at 22.5 percent. The subscribed capital of the EIB will be increased on January 1, 1999, to ECU 100 billion. The paid-in ratio will be dropped to six percent at that time.

Source: Standard & Poor's, *Special Edition on Supranationals*, September 1997.