June 15, 1987

THE INTER-AMERICAN DEVELOPMENT BANK: RE-THINKING AMERICA'S ROLE

INTRODUCTION

The Inter-American Development Bank (IDB), which provides subsidized development loans to Latin America and the Caribbean, is facing a crisis of purpose and funding. The IDB has lent more than $35 billion over the last 26 years. Yet since its clients include Mexico, Brazil, and Argentina, which are among the most troubled of all Third World debtors, the IDB clearly has failed in its fundamental mission of promoting growth and financial stability in the region.

Current negotiations on the Seventh General Increase in Resources for IDB and funding for its highly concessional loan affiliate, the Fund for Special Operations (FSO), have broken down over policy reform issues. The United States and other member countries had proposed a $25 billion capital increase, including $9.3 billion from the U.S., the main financial contributor. But the U.S. Treasury recently withdrew from negotiations and cut to zero its budget request for the IDB from the Congress. The U.S. Treasury apparently is taking this unprecedented but warranted action to reduce the size of the IDB's loan pool in the hope that the IDB would lend its diminished resources more efficiently.

Power in the Hands of Borrowers. The IDB is owned by its 44 member countries, whose subscription to its capital determines each member's voting power. It began operations in 1960 with 20 shareholders--the U.S. and virtually every country in Latin America plus Haiti. Since the 1970s, in an effort to attract additional resources, Canada and 16 countries from outside the Western Hemisphere have been allowed to join the U.S. as non-borrowing members.[1] At the end of 1986, total subscribed capital had reached $34

1. These include most West European countries, Britain, Israel, Japan, and Yugoslavia.

billion; $2.6 billion of this was paid-in and the remainder is callable (in the form of credit guarantees). The resources of the FSO have reached $9 billion. The IDB finances much of its loan program with funds obtained through borrowing in private capital markets guaranteed by its callable capital.

Despite the growth in the number of non-borrowing members, the IDB today remains largely a recipient-run institution. Some 54 percent of its capital is supplied by the Latin American countries. The U.S. accounts for 34 percent, Canada 4.5 percent, and the non-regional members 7 percent. Since the U.S. contributes in dollars and the Latin American nations in their own currencies, the U.S. is the overwhelming source of hard currency for the bank. Voting power, however, is not assigned on this basis but instead has been vested in the hands of borrowers. In return for a new replenishment, the U.S. Treasury has proposed that votes on loan proposals and policy would require 65 percent support rather than the current rule of 51 percent. This would mean the U.S. would need only one ally, possibly Canada, to block unsound loans favored by the Latin American bloc.

The U.S. has a number of convincing reasons for being reluctant to participate in the seventh replenishment. Among them:

1) **Leverage to help improve** the quality of IDB lending. With less money to lend, the IDB would have to be more discriminate about how its capital is used.

2) **Dissatisfaction that the IDB** is run by the countries which receive the subsidized loans. It is the only multilateral development bank (MDB), in fact, in which the loan recipients decide the "who, when, what for and how much" lending questions of the Bank. Control by recipients has hampered the establishment and enforcement of proper economic policy conditions attached to the loans.

3) **Dissatisfaction that the IDB** has allowed itself to become part of an extensive system of Latin American political patronage. It funds parochial projects and employs many friends and relatives of Latin American government officials, as well as former government officials themselves.

4) **Severe U.S. budgetary problems** . The U.S. does not have the resources to supply continual capital increases to the multilateral development banks. It does not make much sense for the U.S. to borrow funds from international markets, provide this money to MDBs, which in turn lend it back to international borrowers--sometimes even back to foreign countries from which the resources came from in the first place.

5) **The highly concessional FSO loans** to such relatively high income nations as Brazil, which can make no objective case for receiving such subsidies.

6) **FSO loans have not promoted** economic growth and development in Latin America's poorest countries. A 1982 Treasury Department study on U.S. participation in the MDBs recommended a gradual reduction in funding levels for the FSO.[2]

7) **IDB and the FSO loans to Nicaragua** . Its leaders can hardly claim to be pursuing economic and political policies deserving the support of U.S. taxpayers.

---

2. U.S. Treasury, U.S. Participation in the Multilateral Development Banks in the 1980s, February 1982.

8) The delay in launching the InterAmerican Investment Corporation. It is the one new facility of the IDB which has a good chance of helping Latin economies.

Latin American governments, multilateral institutions, and U.S. officials must recognize that the Inter-American Development Bank must regain the confidence of the U.S. Congress. This will be possible only if the IDB demonstrates that its loans in fact do trigger economic growth. For their part, Latin American nations must prove they can create the conditions making their economies more responsive to forces of the international marketplace. These countries must attract commercial lending and equity capital.

Get Tough. And the IDB must prove it can assist in this. It must get tougher with those countries unwilling to initiate reasonable economic reforms. For this to happen, the U.S. and other donor governments will have to put greater pressure on the IDB to develop more effective policies for Latin America's economic development. Until IDB does this, the U.S. should provide no new funding for the bank. As such, the U.S. Treasury deserves support for its refusal to participate in the IDB's Seventh Replenishment.

IDB LENDING WORKS AGAINST GROWING WORLD ECONOMIC TRENDS

After nearly three decades of well-intentioned but often ineffective lending, the IDB faces a fundamental challenge. Will it recognize that continuing its project-specific aid to governments is no solution to Latin America's development woes? While IDB lending admittedly has helped Latin America and its commercial bank creditors muddle through the debt crisis, it has not encouraged recipients to lay the economic groundwork to make development projects more self-sustaining.

Since the IDB's lending operations and policy advice are controlled in large part by its borrowers, lending levels and country allocations are highly politicized. There is no truly objective procedure for analyzing the long-term viability of a particular project or considering non-governmental alternatives to the Bank's project lending. IDB lending, moreover, often works against national efforts to attract private capital investment and to spur the creation of local private companies. The Bank's methods of operation rely almost entirely on the public sector to provide the elusive answers to social and economic development.

Working Against Encouraging Trends. Ironically, it seems that the IDB, by not playing a stronger role in shaping market-oriented policies and using its lending more strategically, works against some encouraging new trends within Latin America and international organizations. These are trends toward sensible monetary and fiscal policies, more market-oriented economic policies, and a recognition that liberalized trade spurs growth. In the past seven years, there has been a transition from the rapid expansion of the public sector in the developing and industrialized world to new efforts to find more ways for market incentives to work. This includes ways to make the public sector and state-owned enterprises more responsive to the world economy.

Some Latin American leaders, such as Ecuador's President Leon Febres-Cordero, have on occasion begun to acknowledge publicly that excessive governmental interference (through trade restrictions, heavy public spending, subsidized businesses, commodity cartels, and preferential trade agreements) has failed to increase the economic well being of developing nations.[3] The irony is that while Latin American nations, at times, now call

---

3. See David Asman, "Free Market Theories Become Public Policy in Ecuador," The Wall Street Journal, April 11, 1986, p. 27.

for freer trade and greater private investment, they are lured in the opposite direction by international lending institutions often willing to provide 40-year, 2 percent-interest loans with no strings attached. All that seems to be required implicitly for the loans is that the recipient countries hang on to and expand their bloated bureaucracies and sluggish state-owned enterprises. Faced with a choice between selling off government assets and cutting budgets or accepting outside aid to offset the inefficiencies of both, Latin American political leaders understandably are tempted to make the easier choice. They take the loans and accept their no-growth terms. There is little incentive for these leaders to follow a long-range strategy for growth.

No Strings, No Reforms. The IDB's borrowers receive one basic kind of loan: loans with no strings attached. "Policy-based lending"--loans designed to encourage and reward proper economic reforms--is missing from the IDB system. Typical of the IDB approach is the $24.5 million rural electrification loan to Peru approved earlier this year. For one thing, many aspects of the loan do not even meet standard IDB guidelines. For another thing, and much more serious, IDB officials know that ELECTROPERU, the state-run electicity concern, has long been operating at a negative rate of return and is now likely insolvent. What is worse is that this firm has failed to comply with an agreement in a previous IDB loan to charge market rates. The terms of the new IDB loan do not even specify a target for rates, only a request that ELECTROPERU submit a plan in the future. While the U.S. abstained from the vote on this loan, effectively casting a no vote, the loan was approved.

Another example of IDB lending policy is the recent proposal for a $40 million loan for Guatemala's subsidized housing program. The interest rates of loans to individual borrowers were to be negative in real terms, that is, not even keeping up with the rate of inflation. This disregards the IDB's policy that rates for such loans must be positive. Only after a threated U.S. veto was the proposal redesigned so that positive real rates would be charged Guatemalan nationals.

Half-Completed Plant. The Bank's tendency to take on projects that are economically unproductive and rely too heavily on public financing also is illustrated in the IDB's efforts to expand and modernize a state-supported cement plant in Kingston, Jamaica. The plant, which received large subsidies from the government prior to its funding from the IDB, has never operated at a profit. The Bank nonetheless continues to disburse funds from a $57.2 million loan approved in 1981. And after five years, the plant is only half completed.[4]

The Bank also has heavily subsidized oil and gas operations in Bolivia. Poor planning and chronic delays have plagued most of these projects. A $97 million loan to help build a natural gas pipeline, for example, has been modified several times since its original design in 1982. Contractors in Mexico have delivered less than half of the pipe required for the project. There is a continued shortage of replacement parts. Construction work has not even begun, and yet the Bank insists that the project will be completed within two years.[5]

IDB lending often works against growing national efforts to attract private capital investment and spur the creation of local private companies. The Bank relies almost entirely on the public sector for economic development. There is almost no evidence of IDB operations aimed at market forces and private capital investment.

---

4. <u>1986 IDB Annual Report</u>, p. 84.

5. <u>Ibid.</u>, p. 56.

Dispensing Sound Advice. The IDB and its Fund for Special Operations are only part of the multilateral development bank system, which is in turn part of a very complex international economic system. The financial role these institutions play in any country's development is often overstated. Latin American countries themselves provide between 70 percent and 90 percent of all the capital they use for development. For these countries, obviously, trade is vastly more important in providing foreign exchange and investment capital than are official foreign aid or multilateral banks.

An extraordinarily important role that the banks could play is in dispensing policy advice. IDB managers could nudge recipients of IDB loans to pursue growth strategies. To do this, IDB itself would have to be reformed to enable it to design proper policy changes and allow it to take the political heat in getting them implemented. It would also require a new willingness on the part of debtor countries to accept policy reforms. New multilateral bank financing which require no policy reforms would only perpetuate the earlier flawed development strategies.

Some IDB officials have complained that making sure that each country receives a certain amount of dollars every year has become so important politically that the IDB has lost track of the more important goal of promoting economic growth and development. Those who suggest that less lending and better policy controls might go further toward solving Latin America's debt problems (and, among other things, improving the U.S. trade deficit) are viewed hostilely by IDB leaders. Bank managers rarely seek the more difficult task of linking lending levels with economic policy reforms.

IDB LOANS SUBSIDIZE U.S. COMPETITORS

The IDB often subsidizes U.S. trade competitors, especially in energy, mining, and agriculture. These loans have helped displace private capital investment and turned would-be private enterprises into public works projects, often without regard to supply and demand conditions.

IDB energy loans, for example, have helped insulate Latin American nations from falling world oil prices, a luxury not afforded to America's own energy producers. In 1985, the Bank approved two loans totalling $60.3 million to help expand Argentina's Northern Natural Gas Pipeline. The loans have been used by Argentina's public gas corporation, Gas del Estado, as part of the second stage of an expansion program. The first stage was completed with a $48.4 million loan approved by the Bank in 1980. The IDB estimates this will produce from 9.5 million to 13.5 million cubic meters per day. Firms were given subsidies to expand production during a period of worldwide surplus in natural gas, which continues today.[6]

Subsidizing a Grain Glut. In 1985 and 1986 alone, the IDB approved nearly $2.7 billion in energy, mining, and industrial development projects in 14 countries. This included a $108 million loan to Venezuela to help build a government-owned bauxite mine, a $130 million loan to Chile to help increase mining and other industrial product exports, and a $130 million to the state oil company of Colombia.[7] As much as 25 percent of America's own domestic energy producers are going out of business because of the combined effects of plunging world oil prices, high taxes, and dried-up investment capital. Yet U.S. tax dollars via the IDB are protecting other nations from these circumstances.

---

6. 1985 IDB Annual Report, pp. 48-48.

7. 1985 IDB Annual Report, passim.

The situation in agriculture is similar. Last year the IDB approved $636 million in loans to help boost Latin America's agricultural and fisheries production. Much of this money goes explicitly to increase agricultural export revenue, such as a $60 million loan to the government of Argentina to increase production of grains, oilseeds, and livestock. Approved in 1984, this subsidization of Argentine grain also coincides with a world grain glut. Since 1980, the U.S. share of world agricultural trade (mostly wheat) has fallen from 44 percent to 30 percent, while Argentina's share has doubled. With the current wheat glut on world markets and with the U.S. government advocating and paying farmers not to produce, it makes little sense for the IDB to be encouraging Argentina and other nations to increase production. In making these loans, the IDB displays little sense of global supply and demand conditions. Long-term economic growth is not spurred by subsidizing production of commodities already in oversupply.

THE FSO'S FLAWED LENDING PRACTICES

A March 1985 fact book produced by the IDB describes the Fund for Special Operations as an agency designed to make "long-term, low-interest loans to the less developed countries of Latin America, and for the special purposes which require concessional lending."[8] In practice, however, FSO loans have gone to nations with comparatively high per capita Gross Domestic Products (GDP)[9] and have supported projects which easily could be financed by either the IDB's hard-loan windows or Latin American nations' own domestic budgets. The loans are huge subsidies for these relatively affluent countries.[10] Concessional lending may be appropriate for the world's poorest counties with limited infrastructures and little capacity to generate foreign exchange. But it is difficult to justify providing such favorable terms to far wealthier Latin American nations.

Declining U.S. Contributions. For this reason, the U.S. gradually has reduced its contributions to the FSO over the last decade. In 1976, the Fourth Replenishment of the FSO provided $1.4 billion for three years with $600 million or $200 million per year coming from Washington. The Fifth Replenishment in 1979 provided $1.5 billion for four years with $700 million, or $175 million annually from the U.S. The Sixth Replenishment in 1983 aimed at $700 million over 4 years, with $290 million, or $72.5 million annually, coming from the U.S.

This downward trend, if anything, must accelerate. In a June 11, 1985, letter notifying members of the House Appropriations Subcommittee on Foreign Operations of the status of various multilateral development bank replenishment negotiations (including the FSO), the Treasury Department stated plainly:

> We believe that the question of whether any further replenishment is required should be fully examined. By comparison with other regions of the world, this Hemisphere has relatively few of the poorest countries. It may be possible to

8. Inter-American Development Bank Fact Book, October 1986, p. 12.

9. The GDP/per capita (1985) of recipients of FSO loans in 1986 includes: Bolivia, $840; Brazil, $1,852; Colombia, $1,243; Ecuador, $1,231; El Salvador, $771; Guatemala, $1,216; Haiti, $315; Honduras, $719; Jamaica, $1,698; Mexico, $2,220; Panama, $2,218; and Trinidad and Tobago, $2,375. By comparison, 1984 per capita GNP for sub-Saharan Africa was $420; and the eligibility cap for the 50-year, zero-interest loans of the World Bank's IDA is a per capita GNP of $790.

10. Although FSO terms vary from country to country, average loan maturity is 25 to 40 years, average grace periods are 5 to 10 years, and interest rates are 2 to 4 percent.

meet the needs of these countries for continued concessional assistance by using repayments and income from past FSO loans.

Subsidizing the Wealthy. The record of past FSO lending supports these conclusions. As of December 31, 1986, the FSO had approved a total of $9.37 billion in concessional loans; 51 percent of these have been obtained by 12 countries with a per capita GDP above $1400. Of the remaining nine recipients, only two--Bolivia and Haiti--register per capita GDPs close to those of the concessional recipients of the World Bank.

In terms of allocating loan funds by borrowing member countries, the "Group A" (or wealthy) countries as Mexico, Venezuela, Brazil, and Colombia consistently have demanded that they remain eligible for FSO loans. During negotiations dealing with the Sixth Replenishment of the IDB in June 1985, these nations voted to retain their eligibility for FSO lending.

Over the past five years, the FSO has approved $351 million in loans to Brazil, Colombia, and Mexico, or almost 20 percent of total lending between 1982 and 1986. Though FSO loans are made in local currency and hard currency (usually dollars, Swiss francs, or pounds sterling) or hard currency only, each of these three countries has made their contributions to the FSO in local currencies. The result: these nations use the advantageous terms of FSO loans to borrow the very local currencies they then contribute to the Fund. FSO resources could be channeled more effectively if they were used to help only the most qualified recipients.

FSO LOANS TO NICARAGUA

Not only have FSO loans gone to countries that do not merit them, they also have worked against U.S. political and strategic interests and those of the emerging democracies in Central and South America. Illustrative is FSO help to the Sandinista regime in Nicaragua. The FSO has been involved in a range of projects which subsidize Nicaragua's economy and strangle Nicaraguan entrepreneurs and private business. In 1985, for example, the IDB approved a $55,000 technical cooperation grant from the FSO to assist Nicaragua in updating and fulfilling its Soviet-styled five-year economic plan. This plan was in fact drafted with the help of the IDB and is intended to "improve" government control over all sectors of the economy.

A Road to Suppress the Indians. Other FSO loans have been equally puzzling. The FSO continues to disburse funds of a $65 million loan to help Nicaragua's national bank execute a widespread livestock and agricultural production control program. The loan was originally intended to benefit small-to medium scale private farmers by helping them compete with larger commercial operators. The effect of this project, however, has been to strengthen government farm enterprises, in part by delivering cattle, equipment and machinery to the Nicaraguan government, and in part by forcing individual private holdings to incorporate into larger cooperative enterprises.

Finally, the FSO is actively involved in construction of a 75-mile highway between the cities of Rio Blanco and Siuna in Nicaragua. The new roadway, financed in part by a $32 million FSO loan, with the rest of the project's costs coming from Cuba and the Soviet Union, will serve as the only overland route in Nicaragua between the Pacific and Atlantic coasts. The Sandinistas long have sought access to the more remote Atlantic region, where the regime has been suppressing brutally the low-income farmers and the Miskito and other Indian groups.[11]

---

11. For further detail, see IDB Annual Reports: 1985, p. 91; and 1986, p. 88.

THE INTER-AMERICAN INVESTMENT CORPORATION: A POSSIBLE SOLUTION

If the IDB is serious about improving the quality of its lending, then two important changes are needed as a start:

1) **The FSO should either be restructured** significantly so that only the poorest nations in Latin America receive concessional loans, and that the aid they receive is conditional upon implementing economic reform or it should be eliminated altogether.

2) **The Inter-American Investment Corporation** (IIC) should be strengthened. This new facility has the potential to make significant contributions to sustainable economic growth, if correctly managed by IDB officials.

The IIC's central goal is to encourage the establishment, expansion, and modernization of small- and medium-scale private enterprises. Its March 24, 1986, charter provides for an initial capital stock of $200 million, with the U.S. subscribing 25 percent of the total. Expanding the role of the IIC could shift the economic policy orientation of the IDB, but until now the IIC has lacked enough support from donor and recipient nations to get off the ground. So far, the IDB political and philosophical bias still favors government-to-government programs. The IDB, moreover, apparently remains uncomfortable in addressing the needs of small, evolving businesses in Latin America.

Encourage Reforms. Vigilence will be necessary to ensure that the IIC does not become another conduit of funds for Latin American state-owned enterprises, as is allowed in the IIC charter. Should this occur, the IIC would become just another organization, based on a sound concept of promoting the private sector, whose actual operation becomes permeated by funding government interventions.

The IIC could help ease Latin America's debt problems. First, the IIC could encourage reforms in economic policies and local business laws. Local businesses operating in a more conducive environment are likely to keep their employees and their profits at home, thus reducing the capital flight which drains Latin American nations of hard currency. The ICC also could press for an easing of the burdensome regulations on foreign capital investment such as limits on repatriation of profits, price and supplier controls, and technology transfer requirements. IIC loans should be tied to investment, trade, and tax reform policies that can clear the way for the development of private enterprise.

Second, the IIC can encourage Latin American entrepreneurs by supporting basic business training programs. Entrepreneurial development is the key to success of the private sector in Latin America, as it is elsewhere. The IIC could stimulate new ideas and solutions outside the scope of government as one way to overcome the chronic difficulties of dealing with inefficient and corrupt bureaucrats.

Expand Ownership. Finally, the IIC could explore options for expanded capital ownership, such as employee stock ownership plans and other schemes involving workers in their ownership of Latin American companies. Experience with these plans in the U.S. and Western Europe indicates that worker productivity often rises when employee income is linked to the productivity of the firm. There are clearly many alternatives to state ownership which have not been explored by the IDB and which the IIC could help fashion to fit specific situations in Latin American countries.

For more than a year, IDB members have been bickering over the form of the IIC's investment regulations and the choice of a General Manager. As such, the IIC still is not functioning. In part because of this, Congress did not fund the IIC in the fiscal 1987 foreign aid appropriations bill. Some IDB officials do not expect the IIC to be operating until early next year--if then. At this rate, the IIC can anticipate little or no funding from the Congress in fiscal year 1988 and even beyond.

SEARCHING FOR A LONG-TERM SOLUTION

In its 1986 annual report, the IDB came to an unsurprising conclusion: Latin America requires major new investments if it expects to achieve economic growth and service its debt. But in the search for capital, the Bank's reliance on debt and government programs is unlikely to create the attractive conditions which would prompt local investors to reinvest their own funds and to keep their capital at home, let alone attract new foreign investment.

The Reagan Administration is correct in emphasizing fundamental reform of IDB before new funding is committed to the organization. Treasury negotiators during the current replenishment discussions have held firm on their demand to change the IDB's voting structure. Such a change would allow 35 percent of the Bank's voting rights to block a proposed loan, thus giving the U.S. along with one other donor nation an effective veto. While the U.S. Treasury should be applauded for this, it would be a mistake for Treasury's negotiators to trade the voting issue for a major expansion of the Bank's capital resources. A commitment for the 7th Replenishment could have been $25 billion, which would have nearly doubled the amount of the last Replenishment.

IDB As Cause of the Debt Problem. The investment capital needed by Latin America cannot come solely or even mainly from higher contributions to the Inter-American Development Bank. The sums are too huge. Nor are Latin America's economic problems simply financial. Over the past decade, by lending more on the basis of politics than economics, the IDB has demonstrated that it can be as much a cause of the debt problem as a possible solution to it. Meanwhile, the enormous U.S. federal deficit means that Washington no longer can foot the bill for increased IDB and FSO lending.

The meaning of these developments is clear. In the near-term, the U.S. must continue to refuse to participate in the Seventh General Increase in Resources for the IDB. In the longer term, U.S. participation in the IDB and FSO must be conditioned on these organizations adopting policies and programs which trigger growth in Latin America by unfettering Latin America's potentially creative and dynamic private sector.

Prepared for The Heritage Foundation by
Jeffrey D. Pierson*

---

*Jeffrey D. Pierson is a legislative assistant for Congressman Mickey Edwards (R-OK), who serves as vice-chairman of the House Appropriations Subcommittee on Foreign Operations. The views in this study are those of the author and should not be construed as representing the opinion of any other individual or agency of the U.S. government.