A Dangerous World

Capital is flowing away from those who need it most.

By David Malpass

As the world enters a long period of dangerously slow growth, developing countries are facing the prospect of limited borrowing power and declining development assistance. This comes at just the wrong time. More resources and investment are vital, yet the current fiscal and monetary systems foster inequality and are likely to guide most—if not all—capital away from development.

The Global South is facing massive costs for a multitude of priorities—including health, education, infrastructure, nutrition, and climate. The food, fertilizer, and energy shortfalls stemming from the seemingly endless war in Ukraine will alone cause disruptions for years to come. And it is urgent to recover the years of lost learning due to Covid-19 school closures. Yet capital is flowing away from these needs through the heavy drain by the governments of advanced economies.

Most of the world entered the latest crisis of persistent inflation and rising interest rates unprepared. For the poorer countries, heavy debt burdens had been borrowed at once-low floating interest rates. Their commodity contracts favored external partners, often China, with price-capped commitments to sell their exports but no price protection for their key imports such as grain, natural gas, and fertilizer. These problems require contract restructurings that achieve debt reduction, but the G20 and Paris Club's "Common Framework" heavily favors creditors. The multi-year delays have created instability that undercuts country reform efforts.

David Malpass has served as President of the World Bank Group and Undersecretary of the U.S. Treasury for International Affairs.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

At international meetings that I frequently attended as president of the World Bank Group, one of the principal topics of concern for African leaders has been the security threat as external support shrinks, arms inflows increase in size and sophistication, and debt costs surge. The countries desperately need to build infrastructure and fund internal needs, yet are on the hook for growing payments to both external and internal creditors.

The advanced economies also entered this set of crises with little preparation. Governments had spent decades allowing their deficits to balloon, their dependence on Russia and China to intensify, and their military preparedness to atrophy. They had shortened the effective maturities of their national debts by allowing their central banks to buy bonds long after the 2008 financial crisis. Even before the pandemic, their central banks had huge interest rate risk. They owned long-term bonds financed by overnight interest-bearing liabilities including bank reserves and reverse repos. This compromised their independence in setting interest rates, delaying the response to inflation. They are now suffering both cash flow and mark-to-market losses as rates rise, with the resulting negative equity positions making them dependent on government forbearance.

The certain course for advanced economies is to borrow heavily to fund fiscal deficits and central bank losses. Fiscal deficit projections show drastic increases in their demands on global capital markets due to interest rates, climate costs, and demographics. The U.S. fiscal deficit alone—projected to increase to a staggering 7 percent of GDP—will drain a significant portion of global savings for decades.

Developing countries are facing the prospect of limited borrowing power and declining development assistance. This comes at just the wrong time.

Poorer countries face political and social pressure on their governments, consternation at G7 inaction as China's soft power grows, and for some countries, violent externally funded insurgencies that benefit from poverty and the devastating declines in access to electricity and fertilizer. In meetings of world leaders I attended earlier this year, there were multiple discussions of the need to increase natural gas and nuclear power as transition fuels to support renewables and fertilizer and to harmonize the widely disparate environmental, social, and corporate governance standards and carbon taxes—but no action was taken.

The U.S. fiscal deficit alone will drain a significant portion of global savings for decades.

I also spoke frequently about the inequality caused by the concentration of capital in the advanced economies, the poor structural policies in many developing countries, and the pressing need for comprehensive approaches to improve development outcomes and increase resources. There are no current mechanisms for meeting resource needs, restructuring unsustainable debt, or funding global public goods. The international financial institutions are small compared to the resource challenge and not able to fill the gap. Of particular importance are grants and deeply concessional credits for the poorest countries, yet these are in severely limited supply. For example, the World Bank's grant funding from global governments is only $8 billion per year (of which the United States provides roughly $1 billion, others less.) This is a tiny fraction of the needs and the amounts spent by donor countries on themselves.

As I joined the U.S. government in 1984, the Reagan administration began shifting the mix of development assistance toward grants over loans, recognizing the difficulty countries would face in earning the resources needed for repayment. This evolution is just as relevant now, with debt repayments weighing heavily on development and a big portion of climate costs needing to be borne globally rather than by a sovereign borrower. Funding loan repayments through new multilateral loans (a common practice) undercuts the loan's value for development. Further, as the mix of multilateral financing shifts to loans for climate, the Ukraine war, and repayment of the Covid-19 surge, the need for greater concessional resources (that is, International Development Association and similar non-fragmented funds) increases.

IDA, the World Bank's most concessional funding for the world's poorest countries, has been able to double

Continued on page 55

Continued from page 47
commitments over the past decade, reaching over $90 billion in IDA20, the most recent three-year replenishment. While the cash portion has been stagnating in nominal terms at under $8 billion per year, the major increase in output was possible through the issuance of well-received IDA bonds, the solid reflows from previous IDA loans, and large contributions from the International Bank for Reconstruction and Development's income.

In late 2022, I launched a process to review the World Bank Group's financial model and capacity. A key issue was the financing of global public goods, which requires contributions from all, including concessional resources. The review explored options to increase the World Bank's leverage and financial capacity. Working intensively with the Board, the World Bank completed a deep dive on the Statutory Lending Limit and the Equity-to-Loan ratio. The E/L ratio limit was reduced from 20 percent to 19 percent, in effect raising leverage above five to one, which will increase IBRD commitment capacity. However, the SLL imposes a firm constraint on lending and guarantees. Increasing the SLL requires 85 percent support from shareholders, including a difficult bipartisan change in U.S. law.

The food, fertilizer, and energy shortfalls stemming from the seemingly endless war in Ukraine will alone cause disruptions for years to come.

Underlying the challenges of development, poverty reduction, climate costs, and debt sustainability is the crucial need for global private sector growth. Without robust and inclusive growth, efforts to address the other many challenges will remain elusive. International financial institutions must prioritize policies and investments that foster a conducive environment for sustainable economic growth. During the World Bank Group's review of its policies and resources, I announced an important strengthening of the institution's efforts in private capital enabling with the goal of creating an asset class for the infrastructure needed for development. This direction will be critical for sustainable growth given the limitations on multilateral assistance. ◆