At issue: The World Bank, the IFC and the antecedents of the financial crisis

The financial crisis seemed to come out of the blue, but Paulo dos Santos of the University of London argues that the ground was laid by financial sector privatisation, liberalisation and deregulation. Far from these trends being confined to the rich world, the World Bank and the IFC have played a key role in pushing these policies throughout emerging markets, exposing them to the fallout of the financial crisis.

The World Bank wasted little time in using the financial distress gripping middle-income economies to promote an agenda of privatisation and cuts in state social spending. Yet the orthodox prescription of passing the costs of a financial crisis on to ordinary people through cuts in social services is especially objectionable in the current situation. It will make the recession worse, and it poses a breathtaking double-standard at a time when states in the US and Western Europe prepare to spend more to minimise the damage wreaked on their economies by an unfolding global recession.

It is also particularly offensive given that the World Bank's advocacy and programming over the past ten years directly contributed to the financial vulnerabilities now straining Latin American, East Asian and Central and Eastern European economies. Bank economists led the policy push for the entry of top international banks into middle-income economies. The International Finance Corporation (IFC) provided handsome financial support to the development of many of the financial models and instruments at the heart of this crisis, including consumer and mortgage lending, loan securitisation, mortgage-backed securities, collateralised debt obligations, and originate-and-distribute business models in those countries.

Through these actions the World Bank Group helped install the very financial practices, instruments, institutions and imbalances that triggered the current financial crisis. As in the US, credit systems became focused on lending to individual households, leading to growing personal debt, and to the transfer of rising shares of wage income to the financial system in the form of debt servicing payments and various fees.

The IFC helped fuel lending booms, economic imbalances, and the spread of problematic financial instruments and business models

In many countries, this boom in credit to households resulted in speculative real estate booms and busts, as well as rising trade deficits driven by consumption expenditures. Finally, financial systems developed serious vulnerabilities to financial disruptions in international money markets and in the home economies of foreign banks.

As recent developments in Central and Eastern European economies suggest, banks from developed economies have been central to the spread of the current financial crisis to middle-income countries. Facing a liquidity crunch in their home economies, these banks have cut credit in emerging markets. More significantly, their lending and funding behaviour over the past ten years created serious economic and financial imbalances and vulnerabilities in host countries.

For now the worst consequences of these policies have been borne only by a number of Central and Eastern European economies. But across the developing world many vulnerabilities remain, for which those today raising the mantra of 'fiscal discipline' bear significant responsibility.

Promoting Foreign Banks

The World Bank led research and advocacy efforts in favour of the entry of foreign banks into developing countries, while consistently downplaying concerns about the potential dangers this policy posed. As early as 1988, the Bank advocated the entry of foreign banks in the Philippines, shortly after US negotiators first broached including financial services into the Uruguay Round of trade talks. By the late 1990s, Bank economists had provided the most influential and widely cited theoretical and empirical research papers motivating the entry of foreign banks into developing countries.

Their arguments were chiefly microeconomic. Foreign banks would benefit developing countries by making their banking systems more 'efficient', lowering overhead costs, narrowing interest-rate spreads, and reducing bank profits. They would also introduce 'sophisticated' products and practices, foster the development of ratings agencies and spark better regulation. Few attempts were made to conceptualise the impact of foreign-bank entry on development beyond such narrow micro-level metrics. In fact, Bank economists dismissed concerns that foreign banks may 'cherry pick' and focus heavily on particular market segments, arguing such behaviour would simply be a part of 'market competition'.

During the 1990s a range of states removed restrictions on foreign banks, typically with World Bank support and following a financial crisis. Foreign banks quickly expanded into Latin American, Central and Eastern European and many Asian markets. In Mexico, banks from the US, Spain and Britain came to control about 80 per cent of the banking system. In Europe, particularly the new EU member states, Austrian, Italian, German, Swedish and Greek banks now dominate banking systems. Many of these banks have received considerable IFC financial support during these expansions. Raiffeisen International, an Austrian bank operating across Central and Eastern Europe, received significant equity and hundreds of millions of dollars in loans from the IFC.

Reorientation of Credit

Foreign banks reoriented credit away from the production of goods and services, and towards loans to individuals. They introduced or vastly expanded credit card lending, consumer loans, mortgages, and 'payday loans' guaranteed by future wage earnings. These activities yielded high profits that drew on the wage income of ordinary people, and prompted surviving domestic banks to follow suit.

In Mexico mortgage and consumption lending rose in tandem with the entry of foreign banks, from 15 to 45 per cent of all lending between 1999 and 2007. In Estonia, where over 98 per cent of bank assets were controlled by foreign institutions by 2004, loans to individuals rose from 10 to 46 per cent of all lending between 1995 and the summer of 2008. In the Hungarian financial system, one third of all lending was allocated to households by early 2008.

Corporate reports suggest this lending imposes very high costs on ordinary people. In Mexico, Citigroup and HSBC received $1.9 billion in profits last year from lending to households and related personal financial services. Just in the first six months of this year, Raifeissen International raised 288 million euros in profits from its segment dedi-

cated to lending and financial services to individuals.

By 2006 evidence pointing to these shifts and their likely negative impact on development was mounting. Yet Bank economists continued to advocate the expansion of foreign entry on the grounds they fostered microeconomic 'efficiency'. By that point the reorientation of credit triggered by foreign banks had already shaped serious economic and financial imbalances.

From 2000 onwards the boom in consumption lending significantly pushed up imports, particularly in Central and Eastern Europe. Growing trade deficits meant growing reliance on capital inflows. Further, the boom in mortgage lending inflated real estate bubbles across the region. Both processes were boosted by a particular innovation promoted by foreign banks: lending denominated in euros and Swiss francs. Such loans were increasingly extended to individuals, particularly following the entry into the EU by eight Central and Eastern European countries in 2004.

This lending shared important features with subprime loans in the US. First, it often contained predatory elements, taking advantage of documented tendencies by ordinary borrowers to focus exclusively on immediate monthly repayments instead of overall debt burden when taking on a mortgage. As with 'teaser rates' in the US, banks played up low monthly payments and higher loan amounts that could be obtained with foreign currency loans, often without explaining the risks posed by exchange-rate movements.

Second, foreign banks helped place ordinary borrowers in risky speculative financial positions, sustainable only through a combination of ongoing rises in home prices and a possible future adoption of the euro by the host economy. And third, this lending was driven and boosted by easy access to cheap wholesale funds in international money markets.

The current financial turbulence has exposed how fragile many Central and Eastern European economies became as a result. The credit crunch dramatically reversed capital flows. This is likely to result in devaluations that would impose prohibitive debt servicing costs and mass insolvencies on ordinary people who took out seemingly cheap loans in euros or Swiss-francs from 'sophisticated' foreign banks. The World Bank bears considerable responsibility for this outcome.

Credit and securitisation

Since 2000, the IFC provided significant financial support to banks and other financial firms focusing on credit to individuals, including 'payday loans' to low and mid-income households, broader consumption lending, mortgages and mortgage securitisation. According to its own individual project disclosures, since 2002 the IFC has approved the allocation of at least $3.1 billion to support this lending in major Latin American and Central and Eastern European economies. At the same time less than $2 billion have been allocated to support lending to small and medium enterprises in those countries. Through its support to household lending, the IFC helped fuel lending booms, economic imbalances, and the spread of problematic financial instruments and business models.

The majority of these programmes targeted mortgage lending as part of broader efforts to provide market-based solutions to the serious housing problems in those economies. In this regard, securitisation was to unlock international financial markets and make them 'work for the poor'.

Almost $1.8 billion of IFC support was aimed to promote the originate-and-distribute model in mortgage lending, where lenders do not hold, monitor or service loans, but pass them in bundles to capital-market investors. The IFC was instrumental in the development of mortgage and consumer-credit securitisation in Mexico and Central and Eastern Europe. It argued that secondary markets and securitisation would help support 'the efficient functioning of domestic and international financial markets'.

Through these methods the IFC helped spread the same 'risk-management' techniques, instruments and ratings practices that contributed to the US subprime crisis. This added to the current financial vulnerabilities in Latin American and Central and Eastern European economies.

Loan securitisation is based on the idea that future loan performance will on average be in line with past performance. This may be adequate when trying to predict performance from long-term historical data on similar loans under equivalent economic conditions. But recent lending booms targeted new borrowers with no borrowing history, and took place during the unusually benign macroeconomic picture of recent years. While the booms lasted this raised few questions, not least because these activities remained highly profitable. But the current financial instability and the developing global recession will affect borrowers in unprecedented ways, leading to unforeseen defaults, underperforming assets, and further financial instability.

This is a serious concern in Mexico. Since 2004 the IFC channeled $718 million to support the issuance of more than $4 billion in mortgage-backed securities, most of which were backed by loans to low- and middle-income households. As this issuance expanded, lenders appear to have been taking on increasingly risky mortgages. More recent vintages of those securities are seeing a much more rapid rise in delinquency and default rates than older ones. As the Mexican economy will likely be adversely affected by a downturn in the US, not least through a fall in remittances, default rates will become much higher than estimated during the 'good times'.

And now what?

Unsurprisingly, the actions of the Bank are guided by liberal economic orthodoxy. Housing problems are to be solved through the development of capital markets. Individual competition in banking markets will supposedly guarantee allocations of capital that are optimal for economic development, so long as adequate prudential regulation is in place.

Throughout, Bank policies created profitable business for leading financial firms, drawing on growing shares of wage income in developing countries. In a real sense, liberalisation has not made financial markets work for the poor; it has put the poor to work for financial markets. In exchange, financial markets created serious imbalances in rich and developing economies alike. Now the Bank demands the poor shoulder the costs of the crisis.

The crisis offers an opportunity to contest not simply such policies and demands, but also their pro-market underpinnings. The social provision of quality housing needs to be advanced as an alternative to private provision through capital markets, which has proven so damaging and expensive for ordinary people. The same applies to pensions, health-care, and education, where privatisation has increasingly forced individuals to access capital markets through banks, investment funds and insurance companies to meet their basic needs.

More broadly, the crisis helps underscore the inadequacy of decentralised, profit-driven decisions by financial firms as a foundation for economic development. Alternatives grounded on conscious economic management need urgently to be put back on the development agenda.

December 2008

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Published by **Bretton Woods Project**
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A publication of an independent NGO supported by a network of UK NGOs, the C.S. Mott Foundation and Oxfam Novib.