Europe should boost the Bretton Woods institutions

by Sander Tordoir, 1 December 2023

The EU should reinforce the World Bank and International Monetary Fund to stave off a destabilising financing crunch for many emerging and developing economies.

In the past couple of years, Russia has invaded Ukraine, there have been eight *coups d'état* in the Sahel and there is still a risk of a broader conflagration in the Middle East. On October 24th, the EU's High Representative for foreign affairs Josep Borrell said that the countries in Europe's neighbourhood had turned into a 'ring of fire'. The surge in conflict and instability around Europe is part of a global trend. According to the UN, the world is facing the highest number of violent conflicts since World War II. Two billion people live in places affected.

The reasons behind the global upsurge in violence are not just economic. But a debt crisis in poorer countries may further fuel instability, limiting those countries' ability to fund basic services like health and education. Today, 60 per cent of low-income and 25 per cent of middle-income countries are struggling to pay their creditors or have already defaulted on their commitments.

Generally, developing countries rely on official development aid (ODA), multilateral development banks (MDB), bilateral government creditors and bond markets for outside funding. And if countries are unable to repay their creditors and face a debt crisis, they can go to the International Monetary Fund (IMF) for a bailout.

One of the factors driving the current crisis is that, as global interests rates have risen, it has become harder for poorer countries to obtain funding from private bond markets. Before it dried up, bond market finance had grown in importance. Between 2005 and 2015 it increased three-fold for low-income countries eligible for concessional (below market-interest rate or outright grant) funding from the World Bank and five-fold for lower middle-income countries eligible for its main lending window. Since 2013, many poorer countries have also turned to China, which has disbursed roughly $1 trillion in Belt and Road Initiative (BRI) finance for development projects. But Beijing is bruised from many of its BRI loans going sour in places like Zambia, Sri Lanka and Ghana. China has consequently cut the flow of new lending down to a trickle, although it is handing out some opaque bailouts to countries where it has large financial or political interests, such as Mongolia or Pakistan.

The evolution of bilateral aid from Western countries has been mixed. For example, from 2012 to 2017, total international humanitarian assistance grew by more than 10 per cent a year. But in the four years that followed, this fell to 2.6 per cent, primarily due to a drop in development spending from several European countries, including the UK, that historically have been strong contributors. Meanwhile the World Bank, the oldest and largest MDB, may not have enough money to lend. For example, the size of its support to low- and middle-income countries (the combined assets of the World Bank) grew by roughly 14 per cent from 2013 to 2023, whereas global gross national income increased by over 36 per cent. To put it simply: the World Bank's heft is becoming smaller compared to the global economy.

All this raises the question: who will fill the financing void?

Beijing is confronting a deflating real estate bubble and slowing economic growth at home. It therefore does not seem likely to reverse course and once again provide long-term BRI finance at the same large scale as before. And while China's overseas bailouts to countries in fiscal stress are growing quickly, the terms of these schemes are opaque.

After ceding ground to China in development finance, the US and the EU should now return to the fray. Doing so by strengthening the World Bank and IMF would send a signal to other countries around the world that the transatlantic pair are committed to multilateralism and, unlike China, have poorer countries' best interests in mind. At the same time, it would keep the door open for China, who is also a major shareholder of the IMF and World Bank, to join and step up its support in a much more multilateral and transparent way.

First, the EU should join the US initiative to give the World Bank more funding. The US nominated Ajay Banga as the new World Bank President, who is now trying to stretch its balance sheet, for example by increasing the ratio of loans to its equity. The idea is that the World Bank could use its high credit rating to borrow more money on capital markets and subsequently provide more loans to developing countries. To support that goal, the Biden administration is asking Congress for an additional $2.25 billion capital injection to the World Bank, in the hopes of supporting $25 billion more in World Bank lending. Germany, Japan, South Korea, Saudi Arabia and the Nordic countries are also expected to contribute more.

Banga hopes that all these measures will give the World Bank between $100 billion and $125 billion in extra lending capacity. But, as he admits, that would not be enough for the World Bank to facilitate the investments needed to tackle the most pressing global challenges. It would, for example, not cover the $260 billion the G20 estimates is needed in MDB financing to meet climate goals. And it is far from certain that an increasingly isolationist Congress will release even such a modest amount as $2.25 billion for the World Bank.

The EU should therefore use its own wallet to make the US vision a reality. EU member-states spend almost 0.5 per cent of their gross national income on official development aid, double the proportion of the US. All EU member-states should join Germany and the Nordics in increasing or redirecting a part of these development budgets to boost the World Bank's capital. Giving the World Bank more underlying capital is a far more astute way to scale up its lending than tinkering with the parameters of its existing balance sheet, because it can lend out multiple dollars for every dollar in extra capital it gets.

Second, the US and the EU should get the IMF to temporarily cap its surging interest rates, to make it cheaper for lower- and middle-income countries to service their debts to the IMF. The IMF is indispensable in helping countries recover from balance of payments crises, but its bailout programmes risk losing effectiveness if they swamp countries with unmanageable repayments just as other funding options dry up.

Lower interest rates would discourage debt-distressed countries from turning to deep-pocketed bilateral creditors like China who, unlike the Fund, might prioritise political leverage or access to natural resources over sustainably restoring economic stability. A cap would help countries that have already taken out loans from the IMF's General Resource Account (GRA), which are subject to the IMF's increasing rates. This includes many in Europe's neighbourhood that have such outstanding credit from the IMF's GRA like Morocco ($1.97 bn), Tunisia ($1.8 bn), Jordan ($1.89 bn), Moldova ($0.71 bn), Armenia ($412 million) and above all Ukraine ($12.39 bn).

Alternatives to strengthening the World Bank and IMF are risky. Instead of going the multilateral route, EU member-states could also expand their bilateral aid or give more funding to Europe's development banks. Over the past few years, France for example spearheaded efforts to stem the cycle of poverty and violence in the Sahel through both military intervention and aid. Africa receives one-third of Paris's ODA and three out of its top four recipients are in the Sahel. But the failure of that endeavour is a warning sign not to rely too much on individual EU member-states.

Multilateral institutions like the World Bank can be more effective because they can rally broader global coalitions of donors and partner institutions. They can also ignore the specific national interests of certain EU countries, which could otherwise derail support programmes. Besides, giving more money to multilateral institutions gives the EU an argument to convince like-minded countries that are geographically further from the European neighbourhood – such as Canada, Australia, Japan and South Korea – to contribute more as well.

EU member-states are multilaterally-minded and relatively generous donors, but sometimes seem to lose sight of the big picture. For example, EU member-states, whose economic weight in the world has shrunk, at times seem more concerned about losing relative voting power in the IMF than about keeping the institution relevant in the first place. Yet it makes little sense to be more preoccupied with who gets to drive the fire truck than whether it has enough water to douse the flames.

The EU is concerned about geopolitical fragmentation resulting in a 'deficit in multilateralism'. The US frets about growing Chinese influence. If they want to turn the tide, they should reinforce the World Bank and IMF to support poorer and debt-stricken countries in their time of need. Rebooting Bretton Woods will not cure the conflicts raging on Europe's borders. But it may help by stopping a global financing crunch for emerging market and low-income countries in its tracks. The insight that strong global economic guardrails for countries in distress are a pre-condition for peace was, after all, the reason the allies founded the World Bank and IMF in 1944.

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