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Converting World Bank Loans to Grants in the Poorest Countries Would Reduce Poor Country Debt Without Cost to the U.S.

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President Bush has proposed that up to 50% of the World Bank's lending to the poorest countries be converted to grants focused on education, health care, access to clean water, and sanitation. The World Bank and other critics of the Bush Administration proposal have claimed that it will reduce World Bank lending and require increased contributions from the United States and other G7 countries to compensate the World Bank for the loss of loan repayments. It is implied, although it is not explicitly stated, that poor countries would suffer under President Bush's proposal if U.S. contributions were not increased.

It is correct that, assuming that such loans are repaid, and assuming that there is no increase in G7 contributions, the nominal volume of resources available for World Bank loans would decrease. But it does not logically follow that this would be bad for the poorest countries, or that the poorest countries would suffer a reduction in their net flows from the United States. Indeed, it is logically impossible that a shift from loans to grants would result in a reduction of net flows from the United States to the poorest countries, if we assume that the set of "poorest countries" is fixed for the foreseeable future. There are other reasons why some may object to President Bush's proposal. But it does not make sense to criticize President Bush's proposal for reducing the flow of resources to the world's poorest nations. This briefing paper will explain why this is true.

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To begin with, let us make some simplifying assumptions. Suppose that the set of countries we are talking about is the HIPCs; suppose we stipulate that these are the poorest countries in the world, and will remain so for the next 20 years. (We'll revisit this assumption below.) Suppose that there is no IBRD lending to these countries, only IDA, that this lending it now consists 100% of subsidized loans and that after the policy change it consists entirely of grants in the normal sense. To simplify further, assume that there are only two HIPCs, Tanzania and Mozambique, and that there are no G7 countries besides the United States. Assume that the contribution of the U.S. to IDA is fixed in constant dollar terms at $100 a year. (All dollars here are constant dollars, so we can ignore inflation.) For the purpose of our argument, it makes no difference if the U.S. contribution to IDA is fixed at $100 or $100 million.) Assume that IDA loans are repaid, after a 10 year grace period, in 10 equal installments, at zero real interest.

Consider the grants situation. In year one, the United States gives the World Bank $100. The World Bank then gives $50 to Tanzania and $50 to Mozambique. In year two, and all subsequent years, the same thing happens. The World Bank has exactly as much money to give away as it gets from the United States. Each year, Tanzania gets $50 and Mozambique gets $50.

Now consider the loans situation. In year one, the United States gives the World Bank $100. The World Bank makes a loan for $50 to Tanzania and $50 to Mozambique. The same transfers take place in subsequent years. For the first 10 years, the flows are exactly the same as in the grants case. $100 flows from the United States to the World Bank, $50 flows from the World Bank to Mozambique, and $50 flows from the World Bank to Tanzania.

In the 11th year, the situation changes, because Mozambique and Tanzania start paying back the loan they received in the first year. The World Bank gets a "reflow" of $10 from Tanzania and $10 from Mozambique. Thus, in the 11th year, the World Bank has more money to lend than it would have for grants, if it had only given away grants in the previous 10 years. It has $120 to lend: the $100 it gets from the United States, the $10 it gets from Mozambique, and the $10 it gets from Tanzania. Thus, we see that the World Bank's claim that shifting from loans to grants would reduce their capacity to lend in the future is factually correct. In this example, the money available to the World Bank for lending decreases by 1/6th.

However, focusing on the reduction in lending is misleading, because as the example illustrates, it has absolutely no effect on the net flows from the World Bank to Tanzania and Mozambique. If, as before, the World Bank divides the money equally, then $60 of its $120 goes to Tanzania and $60 goes to Mozambique. Each country is giving the World Bank $10, so the net flow from the World Bank to each country is still $50, exactly the same as in the grants situation.

This is of course as it must be, because "reflows" cannot create money out of nothing. The World Bank could, of course, decide to lend $50 to Mozambique and $70 to Tanzania in year 11, but all they would be doing is effecting a net transfer of $10 from Mozambique to Tanzania.

This illustrates that the only issue, from the standpoint of flows, is who is poor in year 11.

Suppose we remove the assumption that the HIPCs are the poorest countries 11 years from now. Suppose that, as a result of the World Bank's largesse and helpful advice, the HIPCs take off economically, so that in year 11 they are no longer needy, and suppose at that time there are some other countries which are now the "poorest." Then, the World Bank could argue, it would make sense to effect a transfer from the HIPCs, now rich, to some other countries which are now poor. However, few, if any, analysts believe that such a take-off is plausible, and that the HIPC countries will not remain the world's poorest for the foreseeable future.

It is worth noting, in this regard, that there is broad consensus among Administration officials, Members of Congress, and non-governmental organizations that a much larger share of external aid to these countries, including World Bank resources, should be directed to basic human needs: education, health, clean water, sanitation. While such expenditures are certainly desirable, and can be expected to contribute to economic growth and productivity over the long term, many such expenditures cannot be expected to contribute to do so within the next 10 years. Assuming children stayed in school to age 14, for example, universal access to education and health care for children would not be expected to show up in productivity statistics for 14 years after birth. Thus, a loan for education or health care today will not necessarily create increased capacity to service debt 10 years from now, and the money to service that debt 10 years from now, if the debt is indeed serviced, would have to be diverted from something else.

There are reasons why some might favor loans over grants, aside from concern for net flows. For example, some might believe that World Bank lending assures more accountability than grants, or that debt repayment by poor nations serves some other purpose. But we should be clear that there is no reason to expect that substituting grants to the poorest countries for World Bank loans them will reduce these countries' access to assistance.