The Heritage Foundation Backgrounder

No. 668 The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-4400

The Center for International Economic Growth

August 26, 1988

THE INTERNATIONAL FINANCE CORPORATION: THE WORLD BANK'S PRIVATE SECTOR FRAUD

INTRODUCTION

The International Finance Corporation (IFC) is the World Bank's private sector-oriented affiliate. It has been praised by Ronald Reagan for "generating private resources and stimulating private initiative in the development effort."[1] Former Treasury Secretary James Baker lauded the IFC as "the flagship of the private sector in the Third World."[2] World Bank supporters often cite the IFC as a model of what a larger World Bank could achieve. But if the IFC is a model of the depth and sincerity of the World Bank's commitment to the private sector and a reflection of the soundness of its economic policies, both the Bank and the IFC must be judged as bankrupt and Reagan is being misled about IFC performance. In fact, the IFC is yet another reason why the United States should refuse the request to make a $14 billion commitment ($420 million in cash) to the World Bank's proposed $75 billion general capital increase. Nor should the U.S. contribute, as it is being asked, another $35 million as the third of five installments to the IFC's $650 million capital increase.

By the IFC's own admission, only half of its loans are to enterprises that are entirely private. Even this exaggerates the IFC's private sector activities. Investigation finds that many of the enterprises that the IFC classifies as entirely private have extensive public sector involvement. In addition, IFC loans often deter free market development. For example, some loans help perpetuate trade protectionism in the less developed world; other loans hinder efforts to return state-owned enterprises to the private sector. And in Eastern Europe, most IFC loans go into enterprises fully owned or operated by the communist rulers, propping up repressive regimes.

1 *Barron's*, May 13, 1985.
2 Speech at the World Bank 1985 annual meetings, October 3, 1985.

Many of the beneficiaries of IFC loans are large multinational businesses with headquarters in the U.S., Europe, and Japan. The IFC thus provides welfare for the rich.

The IFC's questionable lending policies result from its attempt as an institution to expand its operations for the sake of expansion, even if its efforts are counterproductive.

Benefits Offset. The Capital Markets Division of the IFC, which advises and aids governments in developing their own capital markets, has been the one part of the IFC to contribute to private sector development in the less developed world. But these benefits are more than offset by the damage done elsewhere by the IFC.

The IFC, like the rest of the World Bank, is a highly secretive organization. Information on loans and lending policy is not readily available to the public. Yet what information is accessible suggests that the IFC has disregarded its charter and is wasting billions of dollars, 20 percent from U.S. taxpayers, to support socialism in the Third World. The U.S. Congress should open a full-scale investigation of this massive diversion of funds by the IFC. If the U.S. is to contribute any new funds to the IFC or the World Bank, it must have absolute assurances that the funds will be spent only to promote free market economics and growth-oriented policies in the less developed world.

THE GOAL OF THE INTERNATIONAL FINANCE CORPORATION

The World Bank was established in 1944 to provide capital to rebuild Europe and Japan after World War II. It was believed that private banks would be reluctant to lend money to war-ravaged countries for such public infrastructure projects as roads or electrical power plants. After these countries recovered, the World Bank turned its attention to the less developed world. The Bank receives its funds, as well as government guarantees for its loans, from the various governments that belong to the Bank. The U.S. provides about 20 percent of these funds.

In 1956, the International Finance Corporation (IFC) was created as a World Bank affiliate to promote economic development through private sector activity. Founders envisioned the IFC playing a catalyst role, providing just enough funds in partnership with private businesses to promote general private sector activities. According to Sir William Ryrie, the IFC's chief executive officer, "The main initiative and drive and the bulk of the capital required [for IFC investments] must come from the private sector."[3] Since its inception the IFC has loaned $10 billion. Its outstanding loan portfolio at this time is $2.7 billion. Last year the IFC made over $1 billion in new loan commitments.

3 *The Treasurer* (London), April 1988.

SUPPORTING THE PUBLIC SECTOR

The IFC is supposed to foster economic development by lending money to private businesses operating in less developed countries. Yet many loans go to government owned or controlled enterprises. In its 1987 annual report, the IFC claimed that 41 of its 92 investments in the previous year had gone to entirely private sector entities.[4] It is troubling that an institution that exists supposedly to champion the private sector channels, by its own admission, less than half of its investments to bona fide private companies. It is more troubling when it turns out that many of the companies that the IFC claims are completely private in fact have extensive government participation, if not complete control. The IFC either has little idea of how many truly private sector companies it has invested in or is not telling the truth about the matter.

IFC claims that the Zambia Cashew Company and the Zambian Gwembe Valley Development Company, for example, are completely private.[5] Yet Cecilia Momeka of the Zambian Embassy in Washington explains that the Zambian government owns 51 percent of every corporation in the country.

Extensive Government Roles. In Zimbabwe, the IFC loaned $10 million to udc Ltd., a Zimbabwean finance organization that lends to businesses in that country. The IFC classifies this project as strictly private. Yet, every loan made by udc Ltd. first must be approved by the Zimbabwean Ministry of Industry and Technology or the Ministry of Trade and Commerce.[6] IFC invested $4.5 million in the Keta Basin oil exploration program in Ghana, declaring in its December 23, 1986, press release, "The exploration drilling will be the first carried out by the private sector in Ghana since 1981 and this project is seen as a vital element in renewing the industry's interest in Ghana as a potential petroleum producing area." But officials at the Ghana Embassy in Washington say that their government had an extensive role in the Keta Basin program.

IFC claims investments in three completely private Argentine companies, Arcor S.A.I.C., Juan Minetti S.A., and the Terminal Six Port. In fact, the government of Argentina owns extensive shares in each of these companies.

A November 20, 1985, IFC press release announced a $19.9 million IFC loan for the expansion of the Mari gas field in Pakistan. This project is dominated by Pakistani government corporations.

IFC claims that the China Investment Company is completely private. But the company will be investing in joint projects between the government of China and foreign investors, which the government of China will largely control.

---

4 IFC 1987 Annual Report, p. 15.
5 IFC 1987 Annual Report, pp. 54-63.
6 *Financial Gazette* (Zimbabwe), May 6, 1988.

PROMOTING TRADE PROTECTIONISM

Economic growth ultimately requires open markets. Yet IFC loans actually increase trade protectionism in less developed countries. The IFC has provided five loans to the PanAfrican Paper Mill in Kenya since 1970. As part of the Kenyan government's "assistance" to this mixed public-private enterprise, tariffs on imported paper have been increased sharply. The results looked good in PanAfrican's balance sheets but burdened the Kenyan people with higher paper prices.

In Togo, the IFC claims a $850,000 loan went to a private steel mill. Yet the mill is owned by the government and merely is leased for ten years to a private individual; as part of the leasing agreement, Togo promised to keep a 41 percent tariff on imported steel. Thus, IFC's involvement becomes a subsidy for protectionism.

HINDERING PRIVATIZATION

One of the best ways to promote private sector economic activity and to increase a developing country's economic productivity is to return state-owned enterprises to the private sector, a process widely known as privatization. Yet IFC loans often attempt to rehabilitate failing state industries rather than to privatize them. Government involvement in the economy thus is strengthened and incentives for privatization are removed.

IFC, for example, is planning to extend further loans to the Philippines. *Business Star*, an economic journal in Manila, reported on January 27, 1988, "The International Finance Corporation has offered to fund the rehabilitation of government-owned and government-controlled corporations which have large debts to foreign banks." In the report, IFC chief Ryrie is quoted as saying, "We can help restructure their finances so they can get back on their feet." By this, Ryrie and the IFC are bailing out the white elephants accumulated by the Philippine government during the Marcos years and undercutting privatization.

Web of Government Restrictions. Many IFC loans and investments seek to promote "partial privatizations." Yet partial government ownership and involvement in a business, especially when the government controls most aspects of economic life, amounts to effective government control. In many cases where the government is a minority shareholder, no other shareholder has as large a block of shares as the government. In addition, foreign aid agencies usually are passive investors in such projects, not taking an active role in managing the enterprise. This means that even if the government owns a minority share of the company, it is likely to control it. And most governments in less developed countries impose a web of regulations, licenses, and restrictions on companies to insure that the government will control a firm, regardless of how small its share of ownership may be.

A December 15, 1987, IFC press release boasted, "IFC Helps Privatize Textile Company in Tunisia." But the small print reveals that 49 percent of the company's stock will be held by government holding companies or by government-controlled development finance institutions. Since the IFC tends to be a passive investor, the 49 percent share means that the government probably will retain effective control.

Perpetuating Mismanagement. A July 9, 1986, press release announced, "IFC Helps Privatize and Rehabilitate Farm Project in Mozambique." But though a British firm will be brought in to manage the agricultural project, the government still will own the farms. In addition, the government-owned Bank of Mozambique is a major investor in the project. This is not privatization. The IFC claimed that the project will help "alleviate food shortages" in Mozambique. The major cause of food shortages, however, is the government's agricultural policy. By keeping prices paid for crops low through a government marketing monopoly, and by expropriating the property of farmers, the government of Mozambique destroys the farmers' incentive to produce. It is for this reason that farmers smuggle their crops to neighboring countries to get a better price. Given the socialist nature of Mozambican agriculture, the IFC "privatization" investment is likely only to perpetuate government mismanagement.

IFC has announced that it is privatizing a Rwanda match factory. But, as London's *Africa Economic Digest* reported on April 1, 1988, the restructured match factory still will be 40 percent owned by the government of Rwanda, making it by far the largest shareholder.

BANKROLLING COMMUNIST COUNTRIES

Perhaps the most remarkable example of the IFC ignoring its own principles is its new emphasis on loans to communist countries. Communism by definition excludes private ownership of businesses; in practice, moreover, all but the tiniest mom-and-pop businesses are government owned. Even in these cases, the state typically has effective control of businesses through its total domination of all other aspects of economic life. Presumably, IFC officials are not unaware that their loans to communist countries do not go to private enterprises.

One communist recipient of IFC funding is China. Says the director of IFC's Asian/Pacific branch, Toerstein Stephansen, "Money is available and we can, each year, provide up to $100 million in investment to projects in China."[7] The IFC invested $17 million in a Chinese automobile plant in 1985 in which the only private sector involvement was a less than 10 percent stake held by Peugeot S.A.

Manipulating Criteria. The world's largest current recipient of IFC loans is Yugoslavia, with almost $400 million in IFC assistance. In a 1985 IFC series of one-page summaries of its activities in major borrower countries, each section entitled "Investment Criteria" begins by stating that "While IFC usually invests in private enterprises, it is prepared to support 'mixed' enterprises, i.e., joint ventures between private enterprise and government." But, in the summary for the IFC's activity in Yugoslavia, the "Investment Criteria" section begins "IFC evaluates potential projects on the technical merits, on the economic benefits they will bring to the host country and on the prospects for profits. For IFC to engage in a project,

7 *China Daily* (Beijing), October 2, 1987.

there should be provision for participation, at present or in the future, by local investors of the country in which the project is implemented." By stressing "local investors" instead of private sector, the IFC can call cooperatives controlled by the communist party "private" sector entities and in this way justify its investments. IFC conveniently sweeps its private sector rhetoric under the rug for the sake of its largest beneficiary.

Shrinking Private Sector. As IFC aid to Yugoslavia has grown, the private sector in that country has shrunk. According to Radio Free Europe, the private sector in Yugoslavia has fallen from 27 percent of Gross National Product in 1962 to 5.3 percent in 1986.[8]

The IFC has invested heavily in the Yugoslavian banking system. The IFC thus is likely to suffer heavy losses from last year's sweeping collapse of the Yugoslavian banking system, as well as from the up to 200 percent inflation rate in Yugoslavia. IFC officials insist that their Yugoslavian banking investments are doing well. But it is a mystery how banks can profit from lending money at the negative interest rates prevailing in Yugoslavia.[9]

The IFC recently invested $3.2 million to help set up a new government-controlled bank in Hungary that will make loans to state-owned enterprises and cooperatives. The IFC considers this a triumph because there will be limited minority participation by foreign investors in the bank. But since the government will still control the bank, and the bank will still be lending to government-owned enterprises, this in no way is private sector lending.

Accepting Rhetoric for Reality. While the IFC allegedly is struggling to resurrect the Hungarian private sector, the Hungarian government recently levied new draconian discriminatory taxes on the limited private enterprises that do exist. And the new Hungarian income tax, dubbed by critics as "Swedish taxes on Ethiopian wages," is especially heavy on small entrepreneurs.[10] The efforts of the World Bank and its IFC affiliate probably hinder reform more than they encourage it. Martin Tardos, director of the Hungarian Academy of Science's Institute of Economics, notes that, "The World Bank money has made life easier for the Hungarian government and made it possible to avoid deep market-oriented change. The World Bank was not setting conditions for real changes and they accepted the rhetoric for the reality."[11]

Poland joined the IFC in 1987, and the IFC is eager to disperse loans in that country. Douglas Gustafson, IFC's director of investment for Europe and the Middle East, in a March 24, 1988, confidential memo to the Chairman of IFC's Investment Committee, commented on a pending $18 million loan to a Polish fruit and vegetable cooperative. He stated that, "Given the continuing uncertainties about how and when the IMF [International Monetary Fund] may [give aid to Poland]...there is a real danger that the Polish authorities may become frustrated with the international financial institutions.... IFC has the possibility to act as a bridge during this interim period, by providing a relatively small loan and

---

8 Radio Free Europe bulletin on Yugoslavia, November 1987.

9 Fahrettin Yagci and Steven Kamin, "Macroeconomic Policies and Adjustment in Yugoslavia," The World Bank, July 1987.

10 *The Wall Street Journal,* European Edition, December 21, 1987.

11 Interview with the author, November 24, 1987.

demonstrating the good intent of the World Bank Group.... A fast, early investment by IFC would have enormous effects on IFC's standing in Poland, would demonstrate IFC to be a flexible, responsible institution and would increase the number of investment possibilities in the pipeline. IFC would achieve a great deal of goodwill by an early investment."

Purchasing "Good Will." So much for the IFC fostering the private sector. All that here seems to matter to the World Bank and the IFC is that they may be able to purchase the "good will" of bankrupt communist borrowers as a means to maximize the "investment possibilities" for increased World Bank handouts.

To maintain the fiction of private sector orientation, IFC prohibits guarantees for any specific loan by governments. Yet planned loans to Poland would be guaranteed by the Bank Handlowy, which is fully owned by the Polish Ministry of Finance. The IFC skirts this requirement by claiming that Bank Handlowy is a "commercial bank," and notes, "This approach is similar to that adopted in Yugoslavia and Hungary." An American banker using a similar ruse to dodge legal requirements would end up in prison.

Helping Communist Rulers. If the IFC truly were interested in promoting the private sector in Poland, it would insist first that the Polish government introduce radical free market reforms. According to Jan Vanous of Planecon Consultants in Washington, private Polish citizens have vast dollar reserves saved in their homes and elsewhere safely out of the reach of the government. They do not invest in Polish companies because they do not believe that their investment would be secure against government abuse.[12] It only helps the communist rulers of Poland when the IFC injects dollars into a country because the country's own people have no faith in the economic system.

Perhaps more troubling to Americans than World Bank and IFC support for Poland's socialist economy is their support for Poland's communist political system. Last November, the Polish government held a referendum to get public support for the government's austerity program. Eugenio F. Lari of the World Bank, in an interview with Polish news agency correspondents, urged the Polish people to support the government's plans, even though most private Polish economists scorned the government's proposals, and even though Bank officials are strictly prohibited from meddling in the internal affairs of member countries.[13]

FOREIGN BUSINESS SUBSIDIES

Many of the world's largest and wealthiest corporations reap the benefits of IFC lending. IFC has helped bankroll the activities of Bechtel Group Inc.'s Egyptian branch, Scott Paper Company Inc.'s Costa Rican affiliate, and other overseas operations of major American corporations. Foreign corporations involved in IFC projects have included Siemens A.G. and Daimler-Benz S.A. of West Germany, Barclays Bank of Britain, Bank of Tokyo and

12 Interview with the author, June 5, 1988.

13 Cited in remarks by Radio Free Europe journalist Jacek Kalabinski at The Heritage Foundation, July 28, 1988.

Mitsubishi Motor Corporation of Japan, the Fiat Group of Italy, and other enterprises that hardly can be classified as needy.

Multinationals and Governments. IFC loans often simply underwrite partnerships between multinational corporations and Third World governments. The IFC lent $9 million to the Yemen Hunt Oil Company in 1985 to build a refinery, in a project that also received a $20 million guarantee from the U.S. government's Overseas Private Investment Corporation. Hunt Oil, Inc., a private American company, has been in partnership with the Yemen Arab Republic since 1981. It is difficult to see how IFC cash helps the private sector in Yemen.

A September 22, 1986, IFC press release announced "IFC is lending $190 million - the largest single financing ever undertaken by the Corporation..." to the Trinidad Nitrogen Co. Limited. This corporation, which is owned 51 percent by the Government of Trinidad and Tobago and 49 percent by W.R. Grace & Co. Inc., a private U.S. business, seeks to utilize the extensive natural gas reserves in Trinidad and Tobago. IFC noted that the project "is in line with the Government's policies...of having large projects developed by private groups with Government involvement." Again, how this project promotes the private sector in Trinidad and Tobago is difficult to see.

Project funding for luxury hotels is another way the IFC helps large foreign businesses. The IFC advanced $6 million for a Ramada Renaissance Hotel in Grenada, $7 million for a Sheraton Hotel in Fiji, $3.6 million for the expansion of an Intercontinental Hotel in Kenya. Such projects often are justified by the number of jobs created. The IFC claimed that the $28 million IFC-supported P.T. Bali Holiday Village in Indonesia would create "some 300 direct jobs." [14] But since the average Indonesian per capita income is $750, spending over $90,000 per new job is hardly an efficient use of resources. IFC seems to believe that any job created at any cost is good for less developed countries.

THE IFC'S INSTITUTIONAL EXPANSION

IFC's 1985-1989 five-year plan calls for a 7 percent annual increase in loan-investment volume. Like other parts of the World Bank, the IFC equates its own growth in lending with increasing benefits to less developed countries, no matter how the loans are used. The IFC's 1986 annual report declares, "For the first time in its 30 year history, IFC reported that total investments approved by its Board of Directors topped $1 billion, reaching $1.2 billion, a 23% increase over the previous year." IFC chief Ryrie declares, "We are on the move. The private sector is being encouraged in more countries." [15] Apparently he believes that simply labeling a loan "private sector" guarantees that it will help the private sector even if the loan goes to a government-controlled corporation.

---

14 IFC 1986 Annual Report, p. 46.

15 *Ibid.*

On the other hand, an IFC plan to increase investments in South Korea as a means to meet its growth targets is sending funds where they are not needed. [16] The South Korean private sector is in sound economic shape. Korean businesses currently export such advanced manufactured goods as automobiles, televisions, video cassette recorders, and computer chips. South Korea already has attracted a flood of foreign private investment without the IFC. Economic growth in South Korea has topped 12 percent for the last two years. South Korea has a trade surplus of $6.3 billion. The country does not lack capital. There seems to be little need for IFC assistance.

PROMOTING CAPITAL EXPANSION

The Capital Markets Division is the one exception to the IFC's otherwise dismal record of promoting private sector development in the less developed world. According to the 1986 IFC annual report, "The Capital Markets Division has three main roles: it advises governments on how to organize, modernize, and internationalize their financial markets; it invests in financial institutions aimed at making the financial sector more efficient; and it promotes the flow of foreign portfolio investments." Access to capital and the ability to sell stock in one's company is crucial to economic growth. To this end the Capital Markets Division has helped establish investment trusts for South Korean, Mexican, Thai, and Malaysian companies so that foreign investors could more easily acquire stock in these companies. The companies currently are traded on the New York Stock Exchange. Such mechanisms provide an excellent means for investors to put their money directly into the private sectors of Third World countries.

Beneficial Projects. The Capital Markets Division also has set up an Emerging Markets Growth Fund, a closed-end trust, a form of portfolio containing the stocks of businesses from various less developed countries, which are also traded on the New York Stock Exchange. Portfolios of stock often are easier to sell on a stock exchange than the stocks of individual businesses alone. As the Bank's 1987 Annual Report notes, "While bringing equity from industrialized countries to developing ones, these funds also serve to familiarize foreign investors with local securities markets and improve local companies' access to world capital markets." [17]

The IFC also has created a Foreign Investment Advisory Service to advise Third World governments on policies, regulations, and institutional arrangements that can help spur more foreign private investment in their countries.

These projects operate at relatively low cost to IFC yet provide multiple benefits to less developed countries. IFC's Capital Markets Division acts to facilitate investments rather than actively pouring its own money directly into Third World companies. This role involves less power and prestige for IFC officials, but it directly stimulates the development of real private sectors in the Third World.

16 World Bank 1987 Annual Report.

17 IFC 1987 Annual Report, p. 30.

CONCLUSION

The World Bank is one of the most secretive institutions in Washington. There is no Freedom of Information Act for World Bank documents, and it is almost impossible for private citizens to discover how World Bank funds are invested. World Bank President Barber Conable has done nothing to lift this suspicious secrecy. As available information on the IFC reveals, the main effect of the Bank secrecy is to mask the Bank's real activities in the Third World and Eastern Europe under the pretext of aiding the private sector.

Before any more American tax dollars go to the World Bank or the IFC, Congress should investigate on what the Bank and IFC are spending their money and determine which businesses or governments benefit from this money. If there is a legitimate reason to lend to government-owned or controlled enterprises, or to enterprises in communist countries, the World Bank should make this case openly to the U.S., on its merits, and seek funds explicitly for such purposes. These funds should not be spent under the guise of helping the private sector.

If Congress discovers, as seems to be the case, that the IFC — apparently fraudulently — has misused American taxpayers dollars, then neither the World Bank nor the IFC should receive further U.S. funds. If those organizations are not fundamentally reformed, the U.S. should reevaluate its membership in these bodies.

Opening World Bank Records. Whatever the results of the investigation, Congress should demand that the World Bank and IFC open their records for public scrutiny. In a free society, an open government is the best assurance of an honest government.

Poverty in less developed countries will be eliminated only when they adopt free market policies that spur economic growth. The private sectors in such countries must be free to function with minimum government interference. The mandate of the IFC, to promote private sector development in the less developed world, is a worthy one. Yet the record shows that it almost completely has ignored its mandate, abused its trust, and loaned money to government-owned or controlled enterprises. Its activities have directly benefited communist rulers who to oppress the people of Eastern Europe. Congress should investigate this situation and should make certain that no further U.S taxpayers funds are misused by this bank.

Prepared for The Heritage Foundation by
James Bovard,
a policy analyst for the
Competitive Enterprise Institute,
Washington, D.C.