FUNDRAISING FOR DEVELOPMENT AND ALTERNATIVE FINANCING SOURCES

Address to the

THIRTY-NINTH REGULAR MEETING OF ALIDE GENERAL ASSEMBLY CURAÇAO, NETHERLANDS, ANTILLES MAY 19, 2009

I. THE CURRENT ECONOMIC ENVIRONMENT

I have been asked to address you on the topic of 'fundraising for development and alternative financing sources.' Rather than do so ahistorically, that is to say in timeless fashion, I choose to situate the discussion in the context of the present world economic situation.

There are several dominant features of the current situation, they are:

First, the degeneration of a sub-prime mortgage market crisis concentrated in a few industrialised countries into a global financial crisis immersing banks and other financial institutions in the United States of America (USA), Europe, Japan and to a lesser degree developing countries in Latin America, the Caribbean and Asia.

Second, the onset of global economic recession in the third quarter of 2008, manifested most strongly in the USA and the United Kingdom (UK) but also evident in all of industrialised Europe, Japan and China with spill-over effects on economic growth in emerging economies and low income countries.

Third, massive loss of personal wealth and incomes in the USA and Europe.

Fourth, substantial diminution of equity, major income losses and onset of bankruptcy in the corporate sector of the same countries, affecting major sectors and industries.

Fifth, the collapse of international commodity prices and slower growth in global trade as world economic growth contracted and the speculative boom in commodity prices collapsed.

Sixth, foreign exchange market pressure on the USA dollar and the pound sterling resulting in depreciation of bilateral exchange rates with the Euro.

Seventh, extraordinary claims on the fiscal revenues of the most affected industrialised countries for financing of domestic economic stimulus packages and rescue packages.

II. CUSTOMARY SOURCES OF DEVELOPMENT FINANCE

Developing countries have several fundraising options, each of which has been used at various times. Funds may be raised domestically. One of the methods governments use primarily is issue of medium and long-dated securities to the public. Very often, interest income is tax-exempted to encourage the household sector to invest in such instruments. Domestic financial institutions such as commercial banks, insurance companies, pension funds and social security funds tend to be the main holders of government equity largely because statutory asset portfolio obligations bias their choice in favour of government equities or because of the quasi-political constraint under which social security funds operate in many countries. Another fund mobilisation method is direct borrowing from domestic commercial banks and other private lenders. Although this method has been utilised less than the issue of equities, in some countries it has been used for infrastructure investments which might have been disqualified by application of net rate of return criteria.

There are several limitations to internal fundraising. Among the more important are the potential crowding out of the private sector, foreign exchange pressure and the short-term nature of commercial debt finance. Crowding out occurs when the stock of financial resources (domestic savings) is limited and the government and private demanders of those financial resources are in competition. The analysis of this type of problem is typically situated in the context of government and the private sector (business enterprises) having recourse competitively to bank credit, but it can be extended to access to funds through bond sales where government bonds are competitive with household and corporate savings in financial institutions. Crowding out is less likely when private investment demand is weak and financial sector liquidity is high, as would more be the case in the slump phase of economic cycles or slow economic growth periods. If this is the situation, government fundraising for investment expenditures would tend to be growth promoting rather than growth retarding. Foreign exchange market pressure comes about because of the leakage of domestic expenditures into imports. Many Caribbean countries have high import propensities as a result of which domestic financed expenditures could exert very strong pressures on the demand for foreign exchange and possibly depreciate the foreign currency exchange rate. The short maturities of private commercial credit poses a different kind of problem, namely sub-optimal synchronization between the investment project cycle and the timing pattern of debt payments. Investment projects are generally of medium term duration. Short maturities would therefore entail debt service before the project begins to generate returns.

Development finance has come in large measure from external sources. The main external sources are: (i) bilateral official development assistance; (ii) loans and grants from international financial institutions (IFIs) and from multilateral development banks (MDBs); (iii) loans from commercial banks and other private institutional lenders; and (iv) through issue of foreign bonds. Bilateral official development assistance is the most concessionary in terms of effective interest costs but the most restrictive or 'tied' in its use. Loans from IFIs are generally concessionary but tend to be restricted to economic stabilization. Loans from MDBs are very concessionary, have the longest maturities and have more explicit development orientation whether on a sector or programme basis. In contrast, private market transactors be they financial institutions or individuals provide funds on strictly commercial bases with no concessionality. A further explanation of the interest rate differences between commercial finance and that provided by IFIs and MDBs is the ability of the latter two types of institutions to issue their own bonds on interest terms very favourable to them because of the large size of their issues and the implicit guarantee of their liabilities by shareholder governments.

Even before the present global financial crisis, access to external finance for development has not been problem-free. The efforts of aid-giving OECD countries have fallen short of the

United Nations' target for aid as a percent of gross national income. Aid allocations have been geographically skewed, going mostly to Asia, Africa and the Middle East. As Global Development Finance notes "strategic factors continue to play a major role in the allocation of ODA (official development assistance) across recipient countries. Moreover, aid flows tend to be volatile. This volatility can be associated with expenditure reversals in aid recipient countries, can increase the difficulty of fiscal and monetary policy and exacerbate foreign exchange rate uncertainty. The problems of bunched repayments and mismatch with investment project cycles associated with domestic commercial bank finance are also present when funds are sourced from foreign commercial banks and other private financial institutions. In addition, some governments have made such extensive use of external commercial finance that debt service payments absorb large proportions of fiscal revenues and foreign exchange earnings. With respect to bond finance, the difficulty is essentially one of limited access stemming from the high transactions costs barriers faced by small countries and sub-standard credit ratings for many developing countries. Bond finance on the international capital market is not generally an economical and successful option for most low and middle-income developing countries.

III. SUB-REGIONAL DEVELOPMENT BANKS

Sub-regional development banks provide another fundraising option for developing countries. They are typically owned by a sub-set of developing countries which even though not being of investment grade themselves by resource pooling create an institution that has sufficient size, development reputation and financial market standing to intermediate funds from the international financial community. In a few instances, the sub-regional development banks have non-regional shareholders which by virtue of being investment grade enhance the credit rating of sub-regional banks.

The sub-regional banks have been quite effective in mobilising loans and grants from bilateral official donors and MDBs. They have also succeeded in repeated placement of their commercial paper and bonds on the international capital market. Resources mobilised by the sub-regional banks are sometimes open-ended in use; sometimes, they are purpose specific, more usually when provided by bilateral donors or MDBs. Whether restricted or unrestricted, the resources are disbursed on a loan or grant basis to developing countries. Through this mechanism, the developing countries have greater access to external financial resources for development on financial terms that are often superior to those obtainable if they approached the international market directly.

IV. IMPLICATIONS OF THE CURRENT GLOBAL CRISIS

The global economic and financial crisis reduces access to international finance by developing countries unless the pledges of the Group of 20 countries in April 2009 materialise.

Projections by various international institutions and organisations differ in detail but they all point to a sharp downturn in net private capital flows beginning in 2008 and continuing in 2009. The Institute for International Finance estimates that net private capital flows to emerging markets were 50% smaller in 2008 than in 2007 ($467 billion versus $700 billion) and will decline to $165 billion in 2009. The contraction is greatest in net portfolio investment. Bank lending fell from $410 billion in 2007 to $167 billion in 2008 and is projected to fall to minus $60 billion in 2009. The World Bank (March 2009) estimates that "in 2009, 104 of 129 developing countries will have current account surpluses inadequate to cover private debt coming due…" and that "external financing needs are expected to exceed private sources of financing (equity flows and private debt disbursements) in 98 of 104 countries… implying a financing gap of about $268 billion." Furthermore, much of private debt contracted on assumption of rollover on maturity might not be rolled over in the tighter credit market conditions now prevailing. Developing countries which rely heavily on commercial bank credit are especially exposed to the latter risk.

The price of private market finance has also increased. Daily yield spreads between 3 month LIBOR and the US Treasury Bill rate started to rise sharply from September 2008, and the daily yield spreads on emerging market bonds from July 2008.

Trade credit and direct foreign investment have also diminished synchronously with the global financial crisis. The United Nations Conference on Trade and Development estimates that foreign direct investment decreased by 10% in 2008 and will continue to decrease in 2009. The World Bank speaks of a "drying up of trade finance."

Official flows are not reassuring about the prospects for offsetting the reduced availability of private financial resources. The United Nations World Economic Situation and Prospects 2009 notes that net official flows are likely to be no greater in 2009 than in 2008.

V. THE ROLE OF INTERNATIONAL FINANCIAL INSTITUTIONS AND MULTILATERAL DEVELOPMENT BANKS

The G20 Summit held in London on 2 April 2009 recognised the critical importance of providing development and stabilisation resources to emerging economies: "We have agreed to make available an additional $850 billion of resources through the International Monetary Fund (IMF) and the MDBs to support growth in emerging markets and developing countries by helping to finance counter-cyclical spending, bank recapitalisation, infrastructure, trade finance, balance of payments support, debt rollover and social support."

(Declaration on Delivering Resources Through the International Financial Institutions – London, 2 April 2009)

Within the framework of this programme, the World Bank has initiated a Global Food Response Programme, a Rapid Social Response Fund of $2 billion to be used for safety nets, infrastructure, education and health, increased MIGA's political risk insurance capacity to $2 billion, and set higher targets for its new commitments over the 2009-2011 period to Central and Eastern Europe and Central Asia. The World Bank has also established a Global Trade Liquidity Programme with a target of $50 billion sourced from international finance and development institutions, governments and private banks. This facility is intended to operate through global and regional banks.

The expanded, reformed and new facilities of the IMF are directed towards short to medium-term liquidity needs of member countries. The emphasis is on modifying conditionalities, revising performance criteria, and increasing quota limits which constrain access to fund resources.

The Inter-American Development Bank (IDB), as the regional development bank for Latin America and the Caribbean, has responded to the global financial crisis by creating a $6 billion emergency liquidity facility for commercial banks, expanding its credit for social safety nets, and increasing the size of its Trade Finance Facilitation Programme. The IDB's estimates that its capacity to effectively respond to the increased demand for development finance must be boosted by a substantial increase in its capital base.

Developing countries in Latin America and the Caribbean will not all have access to each of these facilities. In particular, only IDA-eligible countries of which there are nine in Latin America and the Caribbean can have access to the Rapid Social Response Fund of $2 billion which is to be used for safety nets, infrastructure, education and health; similarly for the Global Food Response Programme. This means that most developing countries in Latin America and the Caribbean would be confined to MIGA's political risk insurance programmes, the IFC's crisis response facility for banking, infrastructure and trade funded at $2 billion, and the $2 billion Global Trade Liquidity Programme.

The IMF's Flexible Credit Line (FCL) created in March 2009 would also not be very accessible to most developing countries because they are unlikely to satisfy pre-set criteria with respect to matters such as sound public finance, a record of steady sovereign access to international capital markets on favourable terms, capital accounts dominated by private flows, low and stable inflation, and a comfortable foreign reserve position. Thus far, only Mexico has drawn on the FCL. For most developing countries, access would be limited to the Enhanced Standby Arrangements which have doubled a country's annual limit to 200 percent of quota and increased the cumulative limit to 600 percent of quota.

Given these limitations on access to much of the financial resources promised by the G20m, there is clearly an unfinished agenda for the middle income developing countries in Latin

American and the Caribbean. It is necessary to seek to bring about changes in the policies of the MDBs and IFIs to allow access to the new or expanded facilities.

VI. WHAT ELSE CAN BE DONE?

Stephany Griffith-Jones and Jose Antonio Ocampo (2009) have suggested that developing countries should allocate a proportion of their foreign exchange reserves to the share capital of regional and sub-regional development banks. Their recommended proportion is 1 percent. On their estimates this would generate a $50 billion increase in equity and, with an assumed ratio of loans-to-capital of 2:4, there would be resulting additional lending capacity of $120 billion. This is an attractive proposal which needs to be explored further. One possible difficulty to be addressed is the strong liquidity preferences of Central Banks which hold the bulk of foreign reserves. Another possible problem is posed by the low level of reserves to imports in some countries. An immediate approach to the Griffith-Jones-Ocampo objective might be for the regional or sub-regional banks to place their bonds on a medium-term basis with the Central Banks.

The sub-regional banks could also increase their own credit limits (subject to observance of prudential guidelines), reduce interest charges and make loans for budgetary support. In some cases, there may be need for an increase in the capital base of the sub-regional banks.

A further possibility is for the sub-regional banks to borrow from the MDBs for purposes of on-lending to their own member countries. This option may be attractive to the MDBs because of cost savings associated with making large loans to the sub-regional banks instead of smaller loans to the developing countries. It is also attractive because of the lower risks attached to the debt of sub-regional banks. Important considerations would be the interest rate charged by the MDB and the interest spread imposed by the sub-regional bank.

VII. FINAL REMARKS

There are no magic solutions to the problem of mobilizing financial resources for development. The governments of developing countries and the sub-regional development banks both have to prudent, efficient and innovative in their management of financial resource demands and in their approaches to the external market. Much depends, too, on how accommodative in practice are the policies of bilateral donors, the IFIs and the MDBs.