MDGs and Beyond

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New paths for development finance

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When the Millennium Development Goals (MDGs) expire next year, the world will be able to count many achievements. The number of people lacking access to safe drinking water has been halved, gender equality in education has been strengthened; and health care has become more accessible for millions of people. But there is still much to be done. Many countries are lagging behind, and there is a great deal of discrepancy within countries. The post-2015 development agenda promises to take on the MDGs' unfinished business, while adding objectives related to inclusion, sustainability, employment, growth, governance, and cooperation.

Financing a transformative development agenda will require an unprecedented level of cooperation among governments, donors, and the private sector, as well as policies and institutions that facilitate more efficient use of existing resources and attract new and diverse sources of funding. A recently completed World Bank Group report points to four foundational pillars of development financing: domestic resource mobilization; better and smarter aid; domestic private finance; and external private finance.

Domestic resources constitute the largest pool of funds available to developing countries, which mobilized $7.7 trillion in 2012, largely through taxes, duties, and natural-resource concessions. But, while developing-country revenues have grown 14 percent annually since 2000, average tax revenues in the poorest countries stand at only 10-14 percent of GDP, compared to 16-20 percent in middle-income countries and 20-30 percent in high-income countries. Thus, improved domestic resource mobilization and management would improve the situation considerably.

While developing countries' resources dwarf official development assistance (ODA), which amounted to $128 billion in 2012, they constitute upward of 40 percent of government budgets in fragile and conflict-affected states. Over the last few decades, ODA has played a central role in lifting people out of extreme poverty, financing investments in human and physical infrastructure, and smoothing the path of economic reform. However, we must identify mechanisms for improving aid effectiveness. For example, ODA could be used to attract more private-sector financing, such as through public-private partnerships, in sectors like health care and education.

The third crucial source of development funding is domestic private finance. Financial inclusion, supported by a strong regulatory framework, encourages responsible lending and promotes innovation. It is up to governments to create an environment that enables businesses to take root, compete, and grow, while firms must go beyond minimum corporate social-responsibility standards to help advance human well-being and environmental sustainability. The final piece of the development-financing puzzle is external private funding, delivered via foreign direct investment, international bank loans, bond and equity markets, private remittances, and/or private giving.

This approach to development financing is not entirely new. The 2002 *Monterrey Consensus* emphasized the importance of domestic resource mobilization, aid, investment, trade, institutions, and policy coherence. A "Monterrey II" meeting would help countries obtain a clearer and more realistic picture of the financing sources available, enabling them to prioritize the needed investments – and thus contribute to the successful launch of the post-2015 development agenda.

This note is an excerpt of an article that appeared in Project Syndicate on January 29, 2014.

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Extending financial access to SMEs

Promoting financial deepening and inclusion could accelerate private sector growth, an important driver for poverty reduction and fostering shared prosperity. Indeed, financial institutions facilitate economic growth by mobilizing savings and allocating these savings to the most productive investments.

Not surprisingly, there exists a large body of evidence finding a strong, positive relationship between financial sector development and growth: a well-developed and inclusive financial system also has positive impacts on equality by providing poorer individuals with savings opportunities and much-needed credit.

Without inclusive financial systems, poor people must rely on their own limited savings to invest in their education or become entrepreneurs and small enterprises must rely on their limited earnings to pursue promising growth opportunities. This can contribute to persistent income inequality and slower economic growth.

There exists huge untapped potential in developing countries: around 29 percent of savers worldwide and more than half of savers in 55 economies did not use any formal or semi-formal savings mechanisms, such as formal financial institutions or informal savings clubs.

Improving small and medium enterprises' (SMEs) access to finance will help create more economic opportunities. Access to finance is a major constraint to growth for entrepreneurs in low-income countries. Access to credit and payment services is crucial for the self-employed and SMEs.

Broader access to financial services would help the estimated 400 million micro, small, and medium enterprises in developing countries to prosper. They need financial access to expand their activities, take on new workers, and generate income.

There are 420-510 million micro, small, and medium enterprises worldwide, of which 360-440 million are in emerging markets. When asked to list their main constraints to growth, access to finance tops the list, particularly in low-income countries.

Globally, fewer than 30 percent of these firms use some form of financing that is not self-generated, and half are underfinanced. The total unmet need for credit among SMEs in emerging markets is estimated at US$2.1-2.5 trillion, approximately 14 percent of the total GDP of these countries.

SMEs pose a difficult challenge for financial institutions everywhere. Unlike larger corporates, they offer very little public information and rarely keep accounts in standard and comprehensive formats (much less audited formats). SMEs possess limited fixed assets and few low-income countries have legal and regulatory environments that encourage the use of movable assets (equipment, inventory, accounts receivable, etc.) as collateral. SMEs also need "high touch" services, involving physical access points, while in most low-income countries expanding financial institutions' points of presence is limited to relatively expensive new branch construction.

The Global Partnership for Financial Inclusion (GPFI) recently identified a wide range of new business models providing financial services to fill this gap in a cost-effective manner. Their list includes: i) legal and regulatory reforms; ii) improvements to financial markets infrastructure (financial information supply); and iii) financial services innovations involving new products and new institutional relationships.

Successful models share common characteristics: they reduce costs to serve, using technology and other means; cross-sell multiple products to SME customers; use advanced risk management techniques to maximize the risk/reward balance; and involve strong institutional focus on this specific market segment.

Institutions implementing these models include microfinance institutions reaching up-market (such as the ProCredit Group), commercial banks reaching downwards (dfcu Limited), and a host of non-bank financial institutions and large firms that command supply/value chains.

Countries promoting SME access to finance more successfully, in general, have regulatory frameworks that enable a range of financial products and institutions, including leasing and factoring. These countries have invested in financial markets infrastructure, improved credit information services, strong movable assets systems (including on-line registries), broad electronic payments options (including mobile phone payments channels), and efficient, balanced insolvency rules.

The articles on this page and the following page are based on Financing for Development Post-2015, a World Bank Group report produced by the Poverty Reduction and Economic Management network.

Mobilizing finance for infrastructure

Infrastructure projects often have very long pay-back periods, ranging from 15 to 25 years, and do not always match investors' preference for short-term investment opportunities. In addition, due to potentially high socio-economic rates of return, infrastructure projects in many countries are often not financially viable, as expected revenues are frequently unable to cover project costs given existing tariff structures.

Given the unattractive risk-return profiles of many long-term investments, the actual duration of investors' portfolios can be fewer than 10 years. Only a few developing countries have developed capital markets or banking institutions with the ability to transform short-term deposits into long-term products.

Few infrastructure sectors recover costs easily. It is rare to be able to charge full-cost tariffs. Telecommunication services are an exception and the success in setting adequate user fees has been behind the massive expansion of the sector. Yet, user fees raise concerns of affordability in poor countries, where energy or transport expenditure can take a large share of the incomes of poor households, raising challenging political economy issues.

Besides capital needs, the limited flow of bankable projects because of underinvestment in project preparation represents a major obstacle to public-private partnerships for infrastructure. Improving the quality of project pipelines with sufficient project preparation, including economic, financial, technical and environmental feasibility studies, is critical to clearing the way for private sector participation.

Bankable projects also require adequate legal or guarantees framework for capital mobilization. These challenges are particularly acute for new and emerging technologies, which carry higher risks that are often difficult to measure and price. New technologies can have high operating expenses and are often riskier in the early stages of development. This is particularly true of most green technologies.

Private capital is attracted by the right combination of risk and return. Heightened market and investor uncertainty means that large pools of capital sit relatively idle with few financial interlocutors to deploy in infrastructure. This calls for greater attention to policies and instruments that can lower risk and strengthen the confidence of investors over a long-term horizon.

Sharing risk with the private sector to enhance the viability of investments is one area in which official lenders and Multilateral Development Banks (MDBs) have the capacity and instruments to contribute.

Besides having a cost recovery tariff structure, governments can manage risks to reduce vulnerability, particularly from exogenous shocks. Multilaterals can play a major role on the advisory (capacity and strategy building) and financial sides to help countries reduce their vulnerabilities. The provision of credit, saving, and insurance products can facilitate additional private funding for development, and mitigate the negative consequences of crises.

The World Bank Group has developed catastrophic risk insurance to transfer disaster risk from the government to the financial market, therefore increasing developing countries' financial resilience. Examples include catastrophic risk insurance pools for homeowners' protection in Romania and Turkey, livestock insurance pool for herders' protection in Mongolia, and market-based crop insurance in India.

The official status and financial structures of MDBs allow for greater absorption of both default and political interference risk, making their engagement particularly useful in the early stages of an investment arrangement. MDB guarantees can help draw private capital into higher-risk projects, providing coverage to financially and economically viable projects that would be unlikely to happen without protection against non-commercial risks, and enable investors to access funding on more advantageous terms and conditions.

Risk-mitigation tools, such as guarantees, can be structured to limit the level of risk that investors are exposed to, including country or convertibility risk. For instance, India's Solar Power Guarantee Facility covers up to 50 percent of the payment default risk on commercial bank loans of up to 15 years to private sector developers of small solar power projects.

Modern financial instruments include first loss guarantees in equity or debt funds. As an alternative to charging a fee for first loss guarantees, governments participate in the "equity tranche" of a product in return for taking the first loss risk. In doing so, they provide a first loss guarantee to private investors, while allowing taxpayers to share in potential upside returns associated with the investment. Alternatively, de-risking instruments include currency loans or liquidity facilities, swaps, and derivatives. Clearly, to increase investment in much needed infrastructure in the developing world, these instruments need to be brought to the forefront.

Impact investing: Adding crucial value

By Luther M. Ragin Jr.
President and CEO, Global Impact Investing Network

Impact investments are made with the intention to generate positive social and environmental impact and a financial return. By providing an additional tool for financing solutions to some the world's most intractable problems, the impact investing market has attracted private investors – financial institutions, pension funds, family offices, and endowments – to invest in sectors as diverse as affordable housing, education, sustainable agriculture, healthcare, and financial services for the poor.

Addressing the needs of the poor has long been the focus of government and philanthropic funders. As the impact investing market grows, some have raised questions about how new types of capital might change the market for development overall. Impact investment is not a panacea, but can be an additional – and potentially significant – source of capital to address social and environmental challenges.

Indeed, an effective impact investment market is one that complements and leverages government and philanthropic aid, increasing the funding options available to social entrepreneurs and others developing innovative and scalable solutions.

It also provides new opportunities for government to partner with private investors, bringing additional accountability and increasing the resources supporting job creation, enterprise growth, and other core goals of international development.

By definition, impact investors expect a financial return on capital or, at minimum, a return of capital. As a result, in order to repay investors, prospective investees must have a source of revenue, which might include client payment, grant funding, or a combination of these or other income streams.

As impact investments expand the financing available to socially- or environmentally-focused organizations, grant funders may benefit from a market that helps to more clearly identify those projects and enterprises best able to leverage aid or philanthropic dollars.

Additionally, grants can work in tandem with the impact investments by incubating early-stage business models, providing certain forms of credit enhancement or technical assistance, or funding needed research and development.

The growing impact investment market also opens up new partnership opportunities for government funders. As referenced above, government grant funders may be able to provide credit enhancement that enables private investors with specific risk/return requirements to invest, typically bringing significantly more capital to the table than would have been possible with government funding alone.

Those government funders seeking financial return on capital can also play an important role encouraging partnership, as the UK's Department for International Development (DFID) has done with the DFID Impact Fund, a new GBP75 million fund which is being managed by CDC, UK's development finance institution.

With an explicit requirement that investors from the private sector follow suit, the DFID Impact Fund is serving as the anchor investor in funds whose portfolio companies benefit the poor in Sub-Saharan Africa and South Asia.

It has been nearly five years since the Global Impact Investing Network launched with a mission to help increase the scale and effectiveness of the impact investing market. In just a few years, the market has made notable progress, capturing the interest of diverse private-sector investors, and showing promise for significant growth.

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RESOURCES:

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