

2030 AGENDA FOR SUSTAINABLE DEVELOPMENT

Sustainable Financing for Development

Homi Kharas (Brookings Institution)

Sachin Chaturvedi (Research and Information System for
Developing Countries (RIS))

Mustafizur Rahman (Centre for Policy Dialogue (CPD))

Imme Scholz (German Development Institute (DIE))

March 31, 2019



Abstract

Developing countries face challenges in using cross-border capital flows to fund investments in sustainable development. International financial institutions have a key role to play in minimizing risks to developing economies while ensuring more efficient allocation of public and private capital. However, the global financial architecture is not yet fit for the task. To advance sustainable financing, we recommend that the Japanese G20: (i) agree on measures to catalyze and mobilize private capital in support of the SDGs; (ii) promote measures to improve the allocation of development finance; and (iii) establish, and encourage commitment to, funding approaches for global public goods.

Challenge

It is increasingly difficult for developing countries to use international capital flows to fund investments that would help achieve the SDGs without risks of capital flow reversals, debt crises or other forms of market instability.

International financial institutions have a major role to play in opening up opportunities for greater use of cross-border capital flows for sustainable development, but their governance must be changed to make them fit for this purpose.

The G20 has taken up this agenda in a number of working groups. Most recently, the G20 Finance Ministers and Central Bank Governors formed an Eminent Persons Group (EPG) to recommend reforms to the global financial architecture. This group has presented its recommendations which will now be taken forward by the international financial architecture Working Group.

The terms of reference of the EPG report, however, were focused. The overall challenge at this stage is to combine the recommendations with other elements into a systematic program for advancing sustainable financing.

The Japanese G20 can advance the agenda in three ways.

First, it can agree on measures to increase the level of cross-border capital flows going towards sustainable development, and, specifically, on how to crowd-in greater volumes of private finance through judicious use of public concessional and non-concessional finance.

Second, it can promote measures to improve the composition and allocation of financing to maximize development impact, by building a G20 consensus on creditworthiness analysis, debt transparency and registry, country platforms to coordinate, pool and scale up financing, and greater use of risk mitigation and risk sharing instruments.

Third, it can agree on approaches towards burden sharing and the funding of global public goods to the benefit of all countries, including through innovative financing mechanisms.

Proposal

Despite all the talk about moving from “billions to trillions,” that first surfaced in the Addis Ababa Action Agenda (United Nations, 2015), the empirical reality is that developing countries, net, do not use cross-border capital flows to their full extent. Taken as a group, emerging market and developing economies will have a zero current account deficit in 2019, implying that any capital inflows they receive are matched by an equivalent amount of capital outflows.



This pattern more or less holds across all regions, although there are slight differences. Developing countries in Asia, where infrastructure needs and investment rates are largest, have large enough domestic savings to match their investment rates. Developing countries in Latin America do run small deficits, on average (1.8% of GDP), but have relatively high debt ratios and debt service burdens. Developing countries in sub-Saharan Africa are running current account deficits of about 3.4% of GDP, but much of this is financed through concessional funds.

Paradoxically, globalization has inverted traditional economic views of the desired direction of international capital flows. Rather than encouraging capital to flow to places where it is scarce, globally-mobile capital flows to places where it is most secure. This pattern is creating distortions in the efficiency and equity of investment around the world, especially of government investment.

Recent academic work (Lowe et al. 2018) presents new insights in the relationship between public and private capital which helps to better understand efficient allocation of public capital in particular. Public capital appears to have a higher rate of return than private capital and, indeed, the return on private capital is higher in countries where the level of the public capital stock is higher. They are complements not substitutes. However, the variance of returns is also much higher for public investment compared with private investment. About half of all developing countries seem to significantly underinvest in public capital while half overinvest and invest inefficiently, perhaps because of corruption (Knack and Keefer, 2007).

It is time for the G20 to take stock of upcoming opportunities to promote a more efficient allocation of public and private capital. Here, we recommend G20 actions in three areas: measures to catalyze and mobilize private capital; measures to improve the allocation of development finance; and measures to improve international

collective action in financing goods with global spillovers.

Measures to catalyze and mobilize private capital

The G20 Eminent Persons Group report, welcomed by Leaders in the Buenos Aires communique, has already identified one key challenge for the international financial system as the creation of a large-scale asset class [principally for infrastructure] and the mobilization of significantly greater private sector participation through system-wide insurance and diversification of risk. A number of concrete measures are detailed in the report, starting with a renewed focus on market and creditworthiness fundamentals of good governance and improved human capital, and continuing with ideas about how to reorganize the instruments and work arrangements of the international financial institutions to enable them to work as a unified ecosystem (G20 Eminent Persons Group on Global Financial Governance, 2018).

Implementation details have been delegated to the International Financial Architecture Working Group. In addition, the Buenos Aires meeting catalyzed a number of voluntary commitments to give momentum to the growing groundswell to catalyze private sustainable financing through reporting and information sharing on sustainable investment outcomes, that would in turn permit the creation of more sustainable investment vehicles in capital markets and in private equity and venture capital circles.

G20 countries have the ability to shape a new global social impact investing ecosystem. In a first ever Investor Forum at the G20 Summit in Buenos Aires in November 2018, public and private business leaders agreed to scale up sustainable investments, especially in infrastructure. The call to action identified 7 areas for follow-up that G20 governments can promote through regulations and their own activities, including harmonization of operating principles, ESG disclosures, and long-term sustainability policies, as well as evidence-



based risk profiles. Three specific action areas for infrastructure focus on use of public financial instruments to shift risk, preparation of bankable projects, and creation of country platforms.

The experience of the initial implementation of the ODA private sector window, as laid out in the IDA 18 mid-term review, provides some salutary lessons about the difficulties that are likely to be encountered. There are several windows that have been created to facilitate greater private sector financing in low income countries. While off to a solid start, it seems that the blended finance facility and local currency facility have the most rapid uptakes, while risk mitigation is more complex and requires greater project preparation lead time. Small and medium enterprise financing and agribusiness have been dynamic sectors. The early experience also suggests that private financing in low income countries and fragile states is feasible (International Development Association, 2018). Healthy mobilization ratios (total cost of investment per unit of IDA resources) of 8:1 have been realized.

The G20 should be encouraged to deepen the agenda and monitor its implementation. One important quantitative metric is the degree to which long-term institutional capital from G20 countries is flowing into SDG related investments. For example, the EU has an action plan to reorient capital flows to sustainable investment, to manage financial risks from environmental and social causes, and to foster transparency and long-termism in financial and economic activity.

The Japan G20 Leaders' meeting can serve to:

- Reinforce Leaders' support to the timely implementation and follow-up to the Eminent Persons Group report;
- Identify and share good experiences with expanding sustainable finance, especially by large institutional investors and national and international development banks in G20 member countries;

- Encourage other international financial institutions to study the IDA experience to determine if they too can facilitate greater volumes of private financial flows to developing countries, including to low income countries and fragile states;
- Pursue actions to shape and invigorate social impact investing and sustainable financing investment vehicles to build momentum around private financing for social good;
- Review and monitor the growth in sustainable private financing from each of their countries.

Measures to improve the allocation of development finance

There is a major unresolved dilemma in the allocation of development finance. On the one hand, the estimates of financing needs are very large (hence, “from billions to trillions”). Some countries face particular issues, in particular low income countries, fragile states and selected Least Developed Countries (LDCs). For example, there are 12 LDCs that will graduate from this group in the next few years with consequent loss of duty-free, quota-free preferential market access and aid for trade under the WTO window. They may need special attention for financing to manage the current account deficits during this transition.

Another allocation issue is to match finance with sectoral needs. As a matter of practice, most infrastructure financing would be debt rather than equity. For infrastructure financing, where the volumes are largest, debt would often exceed 80 percent of total project costs. The problem, of course, is that from a macro point of view, many developing countries cannot afford to take on too much debt too quickly—their absorptive capacity is limited. The default is to continue with the current approach that gives pre-eminence to macro debt considerations over micro assessments of the returns to capital.



One proposal is to try to shift financing towards more equity. This would relieve some of the debt pressures but creates problems with affordability. Because equity is far more expensive than debt financing, infrastructure services would need to be priced higher, thereby reducing accessibility.

A balance is needed between macro, micro and affordability/access concerns that should be based on detailed country considerations. Rules-of-thumb are not good proxies in these debates. The costs of erring on the side of too much caution can be very high in terms of foregone opportunities for accelerating SDG related investments. Against that, the costs of erring on the side of too much debt can also be high if this precipitates a crisis.

G20 members are the principal providers of international development finance, but they do not hold similar views on how to strike the best balance. Efforts to forge a consensus on the various economic and political issues are unlikely to prevail; but there can be progress on the overall ecosystem. The G20 can:

- Assist in generating a more comprehensive international debt registry. If each G20 country requested (and then published in aggregate form) information from its own financial firms on the extent of cross-border flows of debt going to governments and public agencies in developing countries, it would be a common basis on which all creditors could make judgments as to country creditworthiness.
- Reinforce the emphasis on improving governance and the rule of law. Although imperfectly measured, existing metrics of governance are the most significant determinant of creditworthiness of developing countries. All G20 members

have an interest in helping countries if they choose to improve institutions that support the rule of law.

- Support developing countries in the creation of sector-specific platforms to generate coherent and high-quality project proposals, linked to national development plans, with capacity for troubleshooting on implementation, harmonization of procedures and pooling of finance and risk mitigation instruments. Such platforms could be used by MDBs and UN agencies to pool their funds in pursuing common goals.
- Encourage international institutions to do more with the private sector, and encourage the private sector to be more responsive to public concerns such as ESG reporting. For example, the Multilateral Investment Guarantee Agency (MIGA) has only paid out 10 claims since its inception in 1988, because it has been proactive in resolving disputes. MIGA has a plan for growth, but, with a level around \$5 billion per year in guarantees, it is too small to have a transformative impact on international development finance. MIGA's country and project size limits could be expanded with support from its G20 shareholders.

Measures to fund global functions

Although there is much talk about the funding of global public goods, this term is too narrow when taken literally as an economic concept, and often too broad when used expansively for any global action. Across a range of sectors, however, there is a strong case for international collective action to fund non-rival and non-excludable functions, like research and knowledge sharing, functions with significant potential spill-overs such as control of pandemics and mitigation of global warming, and global norm setting, visioning, convening and advocacy on policies, such as FAO's principles for responsible investment in food and agriculture (Yamey et al. 2018).



Importantly, the latter includes funding of participants from the Global South in norm setting to ensure inclusive agency.

Aid replenishments

A number of important international agencies are starting negotiations to replenish their funds in 2019 and 2020. Typically, these negotiations are handled on a case-by-case basis; each agency, often using an external facilitator, makes its case independently of others to each of the donors on the basis of a program of work that details the results the agency hopes to achieve.

In 2019/2020, however, the sheer number of agencies and the volume of replenishments suggests that an approach based on a set of core principles would be useful. The replenishments involved are: the Global Fund (6th), African Development Fund-15, IDA-19, GAVI (3rd), Asian Development Fund-13, Green Climate Fund, the Global Partnership for Education (4th) and the International Fund for Agricultural Development-12. In addition, there are calls for additional funding of the Global Agriculture and Food Security Program and for launching the International Financial Facility for Education.

The funds fall into two categories: multisector funds, focused on the poorest countries (IDA and regional bank funds); and vertical funds focused on health, education, climate and food security.

In the last cycle, these funds required about \$65 billion, sufficient to support new spending of about twice that amount (the higher number for new spending is because some funds are now able to borrow in capital markets to on-lend to countries, and significant repayments are falling due on past credits).

Many of these funds face the same sets of issues: ensuring additionality in the face of budget pressures, especially at a time when market access is feasible for many countries (and indeed for many funds); ensuring appropriate focus on low-income and lower middle-income countries; and expanding the base of contributors to enhance the multilateral characteristic of the funds.

G20 members constitute the largest economies in the world, and hence will be the dominant contributors to these and other potential funds. It would be useful if they approached the negotiations in a systematic way. They could learn from the experience of the UN in its new Funding Compact which strives to rectify the imbalance between stagnant core contributions and rising non-core, voluntary contributions that have to be continuously renegotiated. One approach is to make more use of innovative finance mechanisms that can be more stable and predictable than budget-funded ODA. Interesting new ideas include the international finance facility for education (IFFEd).

Negotiations for replenishments of existing funds would be significantly helped if G20 members committed to:

- Maintain commitment levels in national currencies in aggregate to these 9 agencies at least at the level of the last replenishment, thereby allowing donors to reallocate among agencies while keeping constant their overall commitment to the global agenda;
- Support a minimum allocation of concessional funds to low income and lower middle-income countries of 75% (in grant equivalent terms);
- Develop a formula for burden sharing on these and other multilateral agencies with emerging and developing economy



members of the G20, taking into account income levels and size of their economy, to be phased in over time;

- Encourage balance sheet optimization by agencies, including authorization for market borrowing within agreed upon prudential limits.

References

- G20 Eminent Persons Group on Global Financial Governance. Making the Global Financial System Work for All: Report of the G20 Eminent Persons Group on Global Financial Governance. Global Financial Governance, 2018. <https://www.globalfinancialgovernance.org/assets/pdf/G20EPG-Full%20Report.pdf>
- G20 Sustainable Finance Study Group. Sustainable Finance Synthesis Report Executive Summary. G20 Argentina, 2018. http://unepinquiry.org/wp-content/uploads/2018/10/2018_Synthesis_Report_Summary_EN.pdf
- International Development Association. IDA18 IFC-MIGA PRIVATE SECTOR WINDOW (PSW): IDA18 Mid-Term Review. 2018. <http://documents.worldbank.org/curated/en/157801542813052758/pdf/psw-mtr-version-final-published-10252018-636762750312547314.pdf>
- Keefer, Philip and Stephen Knack, "Boondoggles, Rent-Seeking, and Political Checks and Balances: Public Investment under Unaccountable Governments," *The Review of Economics and Statistics*, Vol. 89, No. 3 (2007): 566-572.
- Lowe, Matt, Chris Papageorgiou, and Fidel Perez-Sebastian,
- "The Public and Private Marginal Product of Capital," *Economica*, 2018.
- United Nations. Addis Ababa Action Agenda of the Third



International Conference on Financing for Development. New York: United Nations Department of Economic and Social Affairs, 2015.

- Yamey, Gavin, Osondu Ogbuoji and Kaci Kennedy McDade, “We need a consensus on the definition of ‘global public goods for health,’” *Brookings Future Development* , November 20, 2018, <https://www.brookings.edu/blog/future-development/2018/11/20/we-need-a-consensus-on-the-definition-of-global-public-goods-for-health/>
- Zadek, Simon and Homi Kharas, “Aligning financial system architecture and innovation with sustainable development,” *G20 Insights*, July 25, 2018, https://www.g20-insights.org/policy_briefs/aligning-financial-system-architecture-and-innovation-with-sustainable-development/