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The Future of Development Financing: Challenges and Strategic Choices

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EXECUTIVE SUMMARY

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Executive Summary

At the beginning of the 21st century, more than five decades after international development began to emerge as a field in its own right, the international development financing 'system' is really not much of a *system*. It is rather a collection of disjointed entities that lack coherence, often work at cross purposes and are not up to the task of mobilising finance in the amounts and ways required to assist a growing diversity of developing countries in their efforts to reduce poverty and improve living standards.

The institutions that comprise the architecture of the international development system have grown and expanded by accretion, with one layer of agencies, organisations and programs being deposited on top of previous ones. This expansion has been driven primarily by inertia, special interests and, quite often, fads that have kept alive institutions that should have disappeared, and that preclude the emergence of missing ones to fill obvious gaps. This has not prevented many existing public and private development organisations from doing good work, but has certainly meant that the overall performance and impact of the international development financing system have been well below what is required to support development efforts —and, in particular, to achieve the Millennium Development Goals by 2015.

Thus, in spite of the number and diversity of the institutions, instruments and practices that make up the international development finance system, it appears woefully inadequate to respond to the changing demands emerging from the much more complex realities of global interdependence.

Yet, the early years of the 21st century have brought about an unprecedented 'window of opportunity' for a conscientious re-examination and re-alignment of the institutions and organisations that configure the international development architecture. There is a renewed impetus for reform, partly because global communications have increased awareness of the plight of the poor in developing countries, partly because criticisms about the effectiveness of the development financing system have multiplied, and partly because of increased awareness that the haphazard approaches to reforms of the past have not been successful. In addition, the specific and time-bounded nature of the Millennium Development Goals has helped to focus attention on the inadequacies of current international development financing arrangements. There is also evidence that the terrorist attacks of September 11 2001 have forced political leaders to acknowledge that a series of international security crises may be looming (and perhaps imminent) unless the widespread poverty, marginalisation and growing inequalities that lead to frustration and despair are significantly reduced.

These factors have combined in an international public policy agenda that assigns a significantly higher priority than in the previous three decades to international development concerns. Current attempts to reform the international development financing system appear to be serious and far-reaching, to have engaged a wide constituency and to have generated political momentum.

Sustaining this momentum, however, will require exceptional political will and leadership. The inertias in the 'system' are formidable and there is also a considerable risk that the current sense of crisis and fear could divert development thinking and practice towards narrow and short-term security concerns —such as the 'war on terrorism'. This could highjack the development enterprise in a manner similar to what the Cold War did from the

1950s to the 1980s. Political realities dictate that efforts to reform the international development financing system cannot be on an 'all or nothing' or 'anything goes' basis. If meaningful and sustained reform is to occur, however, it will need to be guided by a long-term vision and what we term in this study a 'radical incrementalism' perspective.

This study explores and develops the alternatives within such a perspective and arrives at an ambitious and extensive menu of strategic choices together with indications of the key actors who will need to make such choices. This is done through the construction of scenarios. Two extreme hypothetical situations are posited, a first in which there are few and mostly inconsequential changes in institutional arrangements over the next decade ("business as usual" or BASU), and another in which the impetus for reform has carried the day and has led to a major restructuring of institutional arrangements including the creation of new entities ("comprehensive reform" or CORE). The study then adds a broad range of possible intermediate situations between these two extremes and derives a suggested framework of strategic choices that will determine the evolution of the international development financing system during the next decade and a half. A set of questions emerges that may be helpful to policy and decision makers in taking stock of the current situation of and in assessing alternatives and prospects for international development financing.

- *How important is finance in the process of development?*

  It is essential. The history of development efforts over the past 60 years demonstrates that without adequate and sustained levels of investment (in all in forms) development simply does not occur. However, while finance is a necessary condition it is far from a sufficient. The broad area of international development finance lies at the intersection of international development concerns and the field of international finance, and refers to the mobilisation of external resources as a complement to domestic savings and investment in developing countries. Different types of developing countries require and rely on distinct combinations of official and private sources of external financing to support their own efforts, but none can remain isolated from the international financial system and expect to produce sustainable improvements in the living standards of poor people. Yet, at the beginning of the 21st century it has become clear that financial resources on their own are of little help in the absence of strong institutions, good governance, sensible policies and the capacity to generate and utilise knowledge.

- *Are the current structures, channels and mechanisms to provide external development finance appropriate to the needs of developing countries?*

  Not really. There is a multiplicity of institutions involved in international development finance but, considered as a whole, they are not up to the task of providing resources to different types of developing countries in the amounts and in the forms required. Current institutional arrangements are characterised by a lack of overall coherence, by policies that are in conflict and that cancel one another out, by an overall governance deficit and by problems in the delineation of mandates. In addition, there is a lack of accountability, insufficient transparency and inadequate representation of developing countries in decision-making. Resource flows are not predictable, some sources of external finance are very unstable, and there is an inadequate match between financing instruments and developing country needs. At the beginning of the 21st century, the structure of international development finance is skewed in favour of highly concentrated and mobile (mostly private) flows to emerging economies and against more balanced and steady long-term flows to emerging, middle-income and low-income countries. There is also a need to address and resolve the growing policy contradiction between multilateral agencies as last resort sources of finance and as performance-based sources of capital.

Efforts are under way to redress this situation through the creation of performance-oriented funds, debt cancellation, instruments to catalyse private flows, special purpose partnerships between public and private entities and the provision of direct budget support, among other initiatives, as well as proposals to create new mechanisms (emissions trading, global taxes, provision and financing of international public goods). However, these efforts have not reached, as yet, a required critical mass and some of them are rather controversial and likely to be counterproductive (e.g. replacing multilateral lending on highly concessional terms with outright grants).

- *What would be the main characteristics of a more effective and adequate set of international development financing institutions?*

  At least eight. These include: *adequacy* (amounts and forms of financing, match between financial instruments and country needs); *predictability* (stability of funding levels, conditions for access to financial resources); *responsiveness* (balance between developing country needs and performance); *diversity and choice* (variety of financial instruments, institutions and programs); *capacity to absorb shocks* (response and smoothing capacity to reduce adverse effects of undesirable events); *complementarity of external financing with domestic resource mobilisation* (external flows should facilitate and help to catalyse domestic financial resource mobilisation and should always aim to avoid 'aid dependency'); *voice, representation and accountability* (capacity to accommodate and respond to the interests and views of all stakeholders); and *flexibility, efficiency and learning* (ability to change and adapt, reasonable costs in relation to benefits, continuous evaluation and feedback). These criteria apply to the set of international development financing institutions as a whole and could thus define an ideal system, but can also be used to assess the effectiveness of an institution. An examination of current arrangements suggests that different components of the international development financing system exhibit these criteria to quite different degrees, and that as a whole it falls short of responding effectively to the needs of developing countries.

- *What are the prospects of international development financing during the next decade and a half?*

  Very uncertain. Yet they are arguably much better at the moment than they have been in at least two decades. The Millennium Development Goals have helped to generate at least some greater political commitment and to reverse the previous decline in ODA. Further impetus was added by the Monterrey pledges made by many countries to increase ODA further and towards the 0.7% target. Additional momentum derives from the collective international unease following September 11 which has led for many to the association of a deeply disturbing causal linkage been poverty and marginalisation on the one hand and interdependent global insecurity on the other. Against these factors that hold promise for development financing prospects, however, is the fact that the international political economy today is characterised by imbalances and distortions of historic proportions and that the development and security agenda has been (and is being) redefined in numerous quarters in terms of a narrow and immediate focus on a 'war against terrorism'. These are factors that risk major negative impacts on the prospects for development assistance. It is also important to note that the next two years may prove especially crucial in terms of these prospects, including those for a post-Monterrey consensus. In 2005 there will be the special session of the UN on the MDGs and the pledges of Monterrey will need to be extended beyond their current framework that extends only to 2006.

Provided reform efforts advance on a number of fronts (several of which are listed below), the set of institutions now active in international development financing could markedly improve their effectiveness. This is envisaged in a *Transformation* scenario where institutional arrangements, financing instruments and different types of developing countries evolve in a positive manner and reinforce each other. Should reforms fail to materialise or to be sustained, however, the outcome would be an *Inertia* scenario that at best would maintain and probably exacerbate the difficulties and problems that international development financing faces at present. A broad range of intermediate outcomes is possible, two of which are envisaged in the *Limited Reforms* and in the *Major Reforms* scenarios. For example, reform efforts could focus on improving development financing for the poorest countries, on creating better conditions for emerging countries to access private capital markets, or on establishing and consolidating public-private partnerships to enhance the capacity of middle-income countries to tap multilateral and private sources of finance.

Advancing from the *Inertia* scenario through *Limited* and *Major Reforms* towards the *Transformation* scenario requires a set of initiatives along three closely interrelated dimensions: *institutional arrangements* for development financing, the array of *financing instruments* to channel resources and the *classification of developing countries* to determine the instruments and institutions that are appropriate for different types of countries. For advances to materialize in the next decade or so, a strategic sequence of initiatives along these three dimensions should be in place during the next three to five years.

- *Is it necessary to explore new ways of classifying developing countries from a development financing perspective?*

Yes, indeed. Country classification schemes based on income per capita criteria (e.g. high, upper middle, lower middle, low income) complemented with ad hoc categories (e.g. low-income countries under stress), do not adequately reflect the main features of developing countries when adopting a development financing perspective, which should focus on their capacity to mobilise external and domestic resources. Two strategic issues, which require further analytical and policy-oriented studies, stand out in this regard.

First, *explore alternative classification schemes* that could reflect the external and domestic resource mobilisation capacity of developing countries, so as to identify the kinds of financial instruments more appropriate to the needs of different types of developing countries. This is closely related to the need for flexibility in defining country category thresholds and for removing barriers that may limit access to some financing instruments. As developing countries evolve in their capacity to mobilize financial resources, the set of financial instruments they employ changes in a natural way in the direction of greater reliance on private sources of capital.

Second, *move beyond the perceived tradeoffs between country performance and country needs in allocating development assistance*, which have characterised aid debates in recent years. Placing countries in categories based just on indicators of performance or of need may not be an effective way of determining the levels and kinds of assistance they should receive, especially when adopting humanitarian and poverty reduction perspectives to balance aid effectiveness considerations.

- *How can change in the international development financing system be brought about?*

  There is a rich and varied menu of strategic issues and options regarding institutional arrangements, financial instruments and developing country classifications can be considered as a 'framework for strategic choices' to advance towards a more effective international development financing system during the next three to five years. These suggest a number of viable initiatives that could be taken to guarantee steady progress in this direction.

  Past experience has clearly shown that major advances in the structure of international arrangements take place at times of crisis. But taking advantage of a crisis requires preparation and a clear vision of where to go —and how to get there— when the crisis arises. Absent a major crisis that would force a fundamental rethinking of development financing —perhaps of the same magnitude of the Great Depression and World War II that ushered in the Bretton Woods agreements—, gradual improvements are the way to proceed. Yet, gradualism needs to be combined with vision in articulating an approach to strategic change, in which a clear conception of the desired ideal future informs and guides the steady steps to be taken. Along the way, it is necessary to remain alert to emerging opportunities to speed the pace of change, such as changes in leadership, which implies having an adequate appreciation of the interests, aspirations and limitations of key stakeholders, and continuous monitoring of events.

- *Who are the main actors in the process of moving towards a more effective international development financing system?*

  The international development finance scene is quite crowded and changes all the time. Its complexity precludes the possibility that a single actor, no matter how powerful and influential, will decide the direction that the evolution of development financing will take. Such an evolution will be the result of collective if disjointed leadership, with some actors playing leading and others supporting roles, and all of them affecting at different times and in different ways the critical choices that will shape the system. In a sense, given the hardened institutional structures and the natural resistance to change of most entities involved in development financing, absent a crisis that would motivate radical reforms, change is most likely to take place through leadership 'seeping through' the cracks of institutional arrangements.

  A multiplicity of actors play leading, secondary and bit parts with scripts that are continuously modified and defy attempts to keep track of a variety of intertwined subplots. The cast of characters will change according to the different initiatives under consideration but it will be drawn from the set of: presidents and prime ministers, heads and senior officers of development assistance agencies or ministries, ministries of finance and foreign affairs, and congressional leaders in donor countries; authorities of the European Union, ad-hoc ministerial groups (e.g. the Utstein group) and the OECD

Development Assistance Committee; heads and senior staff of the World Bank, the IMF, the UN and UNDP, the regional development banks and the specialised UN agencies; presidents, ministers of finance and foreign affairs in developing countries; presidents and senior officers of the leading private foundations and large grant-making NGOs; key executives and senior staff of commercial and investment banks, pension and investment funds, and debt rating agencies; leaders of international civil society organisations; leaders of special commissions and task forces (e.g. the GPG Task Force, the International Panel on Climate Change, the Bretton Woods Committee); and opinion and academic leaders concerned with development issues, including journalists, well-known artists and mass media personalities.

Not all of these are likely to exercise leadership in a positive way. Some may even steer change in the wrong direction or attempt to prevent change from taking place. But, in the last analysis, determined leadership by key stakeholders and actors (who need not be the leading or most visible ones) is essential to keep a steady reform course. Some of these could form temporary alliances to press for specific reforms or work together with more ambitious and long-term aims. In particular, decisive actions of a few developed 'like-minded' countries that are championing the development cause, combined with a greater and more effective participation of developing countries, is likely to lead to substantive incremental changes. Should a major global crisis create the opportunity, such an alliance would also increase the probability of leapfrogging towards a more effective international development financing system.

- *What are the main issues in the reform of institutional arrangements?*

  Many of these issues involve the continuation of reforms now under way that remain essential to improve current institutional arrangements. Among these it is possible to identify: (i) press for and support the current UN reform efforts; (ii) champion international capital markets innovations to better accommodate the financing needs of different types of developing countries; (iii) address the more obvious imbalances, conflicts and contradictions between different official channels for development finance (such as the fact that there are no national constituencies for multilateral agencies); (iv) eschew the proliferation of single-purpose, free standing special funds or secretariats as a substitute for the reform of existing institutions; and (v) recognise the contradictions between issues of voice and of conditionality associated with the fact that there is no 'level playing field' between donor and developing countries in the international financial institutions.

  It is also necessary to prepare the ground for those longer-term fundamental changes in the structure of development financing that will be essential to the criteria of predictability, adequacy and stability. This would necessarily entail recognition that while private flows (including remittances in a globalised order) will play an increasingly important role, there is no substitute for public funding of development assistance. This would further entail recognition that ultimately and in the long run, some sort of automatic mechanisms —such as international fees and taxes levied in small amounts— will be the most efficient way of providing development assistance.

- *Which are the main issues and initiatives regarding financial instruments to channel resources towards developing countries?*

The vast array of existing and proposed financial instruments suggests a rather broad agenda to choose from and focus on during the next few years to improve the prospects for international development financing. Careful strategic choices are required to chart flexible paths toward reform, establishing priorities and defining sequences of initiatives as coalitions of concerned actors define their plans of action. The main issues regarding financing instruments can be grouped into eight categories:

1. Four issues emerge with regards to *bilateral instruments*. First, in addition to increasing bilateral ODA in a substantial and sustainable manner, bilateral ODA debt should be reduced substantially and as a matter of high priority. Second, technical assistance, particularly in bilateral aid, requires fundamental and systematic revamping. Third, reduce the bilateralisation of multilateral aid, primarily by reducing, rationalising and consolidating the large number of special trust funds established in international and multilateral institutions. Fourth, considering the large amount of aid resources at the disposal of the European Union and European bilateral agencies, improve coordination and practices in the delivery of European development assistance.

2. Two main issues can be identified with regards to financial instruments used by the *United Nations, regional and other international organisations*. First, consolidate lines of work, programs and projects, which implies better coordination, greater selectivity, more rigorous priority setting, adopting results-oriented management practices, institutionalising evaluation processes, and possibly merging some of these organisations and agencies. Second, change the patterns of financing of international organisations, which implies providing a larger proportion of core funds in relation to non-core funds to restore a reasonable degree of autonomy to these entities, and also moving from the present mostly voluntary annual funding schemes to multi-year replenishment system with binding pledges for donors.

3. Five issues emerge in relation to the *International financial institutions*. First, there is the question of multilateral debt reduction and the closely related issue of whether to provide grants instead of soft loans, which will determine the future of concessional lending to poor countries, and in particular that of IDA. Second, there is the need to adopt a systemic perspective of the multilateral development banks (MDBs), which implies revising the interrelations between the World Bank, regional development banks, sub-regional development banks and funds that operate like MDBs, considering issues such as net transfers, division of labour and competition, coordination in the field, plurality in policy advice and the range of products and services offered. Third, these institutions should provide additional liquidity to developing countries, primarily a task for the IMF that could involve the creation of Special Drawing Rights or the use of gold reserves to put additional resources at the disposal of their poor member countries. Fourth, these institutions should give greater voice and representation of developing countries. Fifth, it is important to replace graduation from one set of instruments to another with gradation. The existing practice and criteria of formal graduation policies fail to take into account the great variety of financing needs of the various types of developing countries and the unpredictable nature of development itself.

4. Leaving aside perennial issues such as improving the investment climate, harmonizing incentives to avoid a ‘race to the bottom’ to attract foreign capital, better financial regulation and greater transparency, as well as those related to foundation, corporate and individual philanthropy that involve relatively small amounts, three main issues emerge

with regards to *private sources of financing*. First, seek to establish broad understanding of the conditions required for foreign direct investment to occur in poor (and especially the poorest) countries. In spite of the fact that the evidence demonstrates unequivocally that it takes far more than 'good policies' and an open stance both on inward investment and repatriation of profits, much international policy fails to take this into account. In the absence of new and expanded instruments to help create opportunities for foreign direct investments in low-income countries, these investments will simply not materialize. Second, there is the need to build on and expand the modest but successful examples that already exist of arrangements that enhance private foreign investment for infrastructure, an area where developing country needs are huge. Third, it is important to facilitate the flow of remittances and link them to the provision of local public goods, which implies reducing the cost and improving the efficiency and reliability of small transfers sent home by developing country emigrants.

5. Only a few of the larger and at least somewhat advanced of developing countries have managed to gain any significant degree of access to *international capital markets*. This, of course, reinforces the critical financial intermediation role of the IFIs for such countries, but wider and improved access by poorer countries to international capital markets could be facilitated through new instruments and the creation of secondary financial markets. Two issues can be identified in this regard. First, develop and promote the use of innovative instruments in developing country sovereign markets, such as bonds indexed to GDP or other variables, collective action clauses, sovereign debt rating schemes, and utilizing bilateral, multilateral or foundation support to guarantee interest payments. Second, provide support for the creation of new investment funds for developing countries, which could focus on specific sectors (e.g. energy, transport infrastructure, commodities) or on firms with special characteristics (e.g. socially responsible investment).

6. There is such strong opposition in many advanced countries to any notion of *international taxes, fees or other charges* that the best strategic option in this area would involve support for careful and detailed studies to design international tax arrangements that would be perceived more as win-win than is the case today. The most immediate issue in this area to which priority study attention could be assigned would be on the possibility of creating some type of carbon tax, taking advantage of the growing concern about global warming.

7. Two issues emerge with regards to the *creation of markets* that may channel additional resources to developing countries. First, there is the creation and expansion of emissions trading mechanisms for greenhouse gases, particularly now that the Prototype Carbon Fund at the World Bank and the Chicago Climate Exchange have shown that such a market could work, and the EU emission trading scheme is to be launched in 2005. With the ratification by Russia of the Kyoto Protocol it will now come into force and there is the need to support developing country efforts to actively participate in it. Second, there is a need to create markets for the provision of undersupplied public goods of importance to developing countries such as vaccines for tropical diseases.

8. Finally, three strategic issues emerge in the varied group of financial instruments associated with global and regional partnerships. First, support the consolidation of special purpose global funds, which combine official institutions, international organizations, foundations, private firms and capital markets, to focus attention and

resources on specific problem areas. Care should be taken to avoid the proliferation of independent initiatives that disperse efforts and increase administrative and transaction costs. Second, actively promote the creation of regional and local partnerships and the spread of best practices to fund development initiatives involving bilateral and regional agencies, developing country governments, non-governmental organisations, foundations, private firms and community organisations. Third, support the United Kingdom proposal to establish an International Financing Facility and related initiatives, which could substantially increase and front-load aid resources by combining actions by donor governments, capital markets, and multilateral institutions.

As mentioned before, in the past a series of crises strengthened the resolve of political leaders to act boldly and to introduce structural reforms in the conduct of international affairs. The tragedies of World War I, the Great Depression, World War II, among many others that characterized the 20th century, spurred in the 1940s a series of major institutional innovations. They led to the creation of the United Nations, the Bretton Woods Institutions and the launching of what may be called the 'international development experiment'. Sixty years later, when global interdependence has increased to previously unthinkable levels —and when poverty, destitution, exclusion and violence are continuously but fleetingly brought to our attention under the harsh light and the magnifying glass of global mass media— the whole array of international institutions to preserve peace and promote development are under severe stress. This requires a fundamental shift in the way international economic, social and political relations are managed and, in particular, it poses the challenge of creating a new and more effective international development financing system.

Radical incrementalism —an oxymoron that fits well the paradoxical character of the emerging fractured global order— may be the best approach to advance towards the *Transformation* scenario for development financing in the mid-2010s. It implies the simultaneous articulation of a shared vision of the desired future and the design of pragmatic, down to earth, means to approach it. Both vision and pragmatism are required to launch and sustain the reform process along a broad front of initiatives. Political will and courage, together with determined leadership and the ability to mobilise support coalitions, will be essential to steady, incremental progress in transforming the vast and complex international development finance system into a truly effective instrument for development. A sense of utmost urgency must drive and spur reform efforts. Otherwise, tragedies and catastrophes will occur sooner or later, as they did in the 20th century. These would probably then steel political resolve and catalyze action, but not before paying a heavy toll in human suffering and widespread misery.

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