THE FUTURE OF DEVELOPMENT FINANCING

Challenges and Strategic Choices

Francisco Sagasti, Keith Bezanson and Fernando Prada

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The current study builds on a previous project, the Development Finance 2000-initiative. Leading up to the UN conference on development finance in Monterrey, March 2002, Sweden published studies on issues about the financing of multilateral aid, and of global public goods. The current study pulls threads together in an attempt at looking at all the components in the international *system* for development finance, and where that is likely to go in the near future.

The arguments and positions expressed in this study are those of the authors, and do not necessarily reflect the views of the Swedish government.

Another task of the secretariat is to serve the EGDI (Expert Group on Development Issues), in its task of channelling research findings into the heart of policy making. The EGDI is an independent group of internationally renowned researchers and policy makers.

For further information, please contact:
The EGDI Secretariat
Ministry for Foreign Affairs
Department for Global Development
SE-103 39 Stockholm, Sweden

Phone + 46 8 405 10 00
Fax + 46 8 723 11 76

egdi.secretariat@foreign.ministry.se
www.egdi.gov.se

List of Acronyms

ACC	Administrative Committee on Co-ordination
ACP	African Caribbean and Pacific countries
ADRs	American Depositary Receipts
AfDB	African Development Bank
AfDF	African Development Fund
AFESD	Arab Fund for Economic and Social Development
AIDS	Acquired Immune Deficiency Syndrome
APEC	Asia Pacific Economic Forum
AsDB	Asian Development Bank
AsDF	Asian Development Fund
ASEAN	Association of Southeast Asian Nations
BADEA	Arab Bank for Economic Development In Africa
BASU	Business As Usual
BCIE	Central American Bank for Economic Integration
BOAD	West African Development Bank
BWI	Bretton Woods Institutions
CABEI	Central American Bank for Economic Integration
CAC	Collective Action Clauses
CAF	Andean Finance Corporation
CAS	Country Assessment Strategy
CCA	Common Country Assessment
CDB	Caribbean Development Bank
CDF	Comprehensive Development Framework
CFF	Compensatory Financing Facility
CLAC	Collective Action Clauses
CORE	Comprehensive Reform
CPIA	Country Policy and Institutional Assessment
DAC	Development Assistance Committee
DFID	Department for International Development
EADB	East African Development Bank
EBA	Everything But Arms
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECLAC	Economic Commission for Latin America and the Caribbean
ECOSOC	Economic and Social Council (UN)

EDF	European Development Fund
EEC	European Economic Community
EFF	Extended Fund Facility
EIB	European Investment Bank
EMP	Emerging Markets Partnership
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FAO	Food and Agricultural Organization
FDI	Foreign direct investment
FLAR	Latin American Reserve Fund
FONPLATA	Fund for the development of the Rio de la Plata Basin
FSAP	Financial Sector Assessment Program
FSO	Fund for Special Operations
FTAA	Free Trade Agreement of the Americas
GAVI	Global Alliance for Vaccines and Immunisation
GDP	Gross Domestic Product
GEF	Global Environment Facility
GMO	Genetically Modified Organisms
GNP	Gross National Product
GPG	Global Public Good
HIPC	Highly Indebted Poor Countries
IADB	Inter-American Development Bank
IAEA	International Atomic Energy Agency
IBCA	Intervest Bancshares Corporation
IBRD	International Bank for Reconstruction and Development
ICAO	International Civil Aviation Organization
ICSID	International Centre for the Settlement of Investment Disputes
IDA	International Development Assistance (World Bank)
IDB	Islamic Development Bank
IDRC	International Development Research Centre
IEO	Independent Evaluation Office (IMF)
IFAD	International Fund for Agricultural and Rural Development
IFC	International Finance Corporation
IFF	International Finance Facility
IFIs	international financial institutions
IFS	International Foundation for Science
IIC	Inter-American Investment Corporation
ILO	International Labour Organization

IMDIS	Integrated Monitoring and Documentation System
IMF	International Monetary Fund
IMO	International Maritime Organization
IsDB	Islamic Development Bank
ITU	International Telecommunication Union
LDCs	least developed countries
LICUS	Low Income Countries Under Stress
LILs	learning and innovation loans
MCA	Millennium Challenge Account (US)
MDBs	Multilateral Development Banks
MDGs	Millennium Development Goals
MERCOSUR	Common Market of South America
MIF	Multilateral Investment Fund
MIGA	Multilateral Investment Guarantee Agency
MTP	Medium Term Plan
MYFF	Multi-year Financial Frameworks
NADB	North American Development Bank
NAFTA	North American Free Trade Agreement
NDF	Nordic Development Fund
NEADB	North East Asian Development Bank
NEPAD	New Partnership for African Development
NGOs	non-governmental organisations
NIB	Nordic Investment Bank
NIEO	New International Economic Order
NPV	net present value
ODA	Overseas Development Assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
OPEC Fund	Organization of Petroleum Exporting Countries Fund
OPIC	Overseas Private Investment Corporation
PRGF	Poverty Reduction and Growth Facility (IMF)
PRSPs	Poverty Reduction Strategy Papers
R&D	research and development
RBB	Results-Based Budget
RBM	Results-Based Management
RDBs	regional development banks
ROSC	Reports on Standard and Codes
RPG	Regional Public Good
SADC	South African Development community
SDDS	Special Data Dissemination Standard

SDRM	Sovereign Debt Restructuring Mechanisms
SDRs	Special Drawing Rights
SRDBs	Sub-Regional Development Banks
SRF	Supplemental Reserve Facility
SRI	socially responsible investment
SWAps	sector-wide approaches
TOKTEN	Transfer of Knowledge through Expatriate Nationals
UK	United Kingdom
UN	United Nations
UNCDF	UN Capital Development Fund
UNCHS	UN Centre for Human Settlements
UNCTAD	UN Conference on Trade and Development
UNDAF	UN Development Assistance Framework
UNDG	United Nations Development Group
UNDP	United Nations Development Programme
UNEP	UN Environment Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNFIP	UN Fund for International Partnerships
UNFPA	UN Population Fund
UNHCR	UN High Commissioner for Refugees
UNICEF	UN Children's Fund
UNIDO	UN Industrial Development Organization
UNITAR	UN Institute for Training and Research
UNRWA	UN Relief & Works Agency for Palestinian Refugees in the Near East
UNU	United Nations University
UPU	Universal Postal Union
US	United States
USAID	United States Agency for International Development
WB	World Bank
WEF	World Economic Forum
WFP	World Food Programme
WHO	World Health Organization
WIPO	World Intellectual Property Organization
WMO	World Meteorological Organization
WTO	World Trade Organization
WWII	World War II

Preface

International development emerged as a field of activity and of scholarship in its own right during the second half of the twentieth century. More than five decades later, it is generally acknowledged that adequate and sustained levels of investment in all its forms are essential for economic growth and for improving living standards in poor countries. There is also, however, widespread realization that financial resources are a necessary but not a sufficient condition for development: on their own, and in the absence of strong institutions, good governance, sensible policies and the capacity to generate and utilize knowledge, they are of little help. One consequence of this realization has been a steady growth in the number and reach of entities that provide financial and development resources assistance to developing countries. These now comprise a large network of public and private national, regional and international organizations that are usually referred to as the 'international development financing system'.

This 'system', however, 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 mobilizing 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.

In spite of this – and also because of it – the early years of the twenty-first century have brought about an unprecedented 'window of opportunity' for a conscientious re-examination and re-alignment of the institutions and organizations 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 (MDGs) 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 caused political leaders concern that deeper international security crises may be looming (and perhaps imminent) unless the widespread poverty, marginalization and growing inequalities that lead to frustration and despair are significantly reduced.

Whatever the relative weights one assigns to these factors, the first years of the twenty-first century are characterized by a much greater international focus on development financing issues than in the previous three decades. 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 substantial political momentum.

Sustaining this momentum 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 hijack the development enterprise in a manner reminiscent of the impact of the Cold War 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 reforms are to occur, they will need to be guided by a long-term vision, to focus on clearly articulated strategic choices, and to identify practical and politically viable short-term actions – what we term in this study a 'radical incrementalism' perspective.

This perspective informs the approach and theme of this book. It leads to a 'framework for strategic choices' and to the identification of the key actors that will make such choices. This is pursued through the construction of scenarios that combine institutional arrangements, financing instruments, categories of countries and political viability, and through an analysis of the policy implications of alternative scenarios. This study, therefore, does not offer a 'blueprint' for change, but rather a set of options from which to choose in order to reform international development finance.

The first chapter outlines the legacy of more than five decades of growth and change in the international development financing system, and ends with a critical assessment of its main defining characteristics at the end of the twentieth century. Chapter 2 reviews and summarizes the main recent attempts to reform the international development architecture, focusing on actions undertaken by United Nations bodies, international financial institutions, bilateral aid agencies and the European Union, and also on initiatives to establish new sources and mechanisms for development finance.

Chapter 3 begins by suggesting the attributes of an effective international development financing system. It then describes the components of four scenarios that portray alternative futures for development financing in or about 2015 (the established target date for achieving the Millennium Development Goals). The first component, institutional arrangements, posits two extreme hypothetical situations: one in which there are few and mostly inconsequential changes in institutional arrangements ('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). A broad range of possible intermediate situations between these two extremes is then briefly discussed. The second component introduces considerations regarding the range of existing and proposed financial instruments to channel resources to developing countries. The third component explores the ways in which developing countries are classified – usually according to their income per capita levels – and concludes that this is not very useful for development financing purposes. A new approach to categorize countries in terms of their capacity to mobilize external and domestic financial resources is then proposed. Chapter 3 closes with a discussion of political viability, the fourth and final component of the scenarios, outlining trends in international relations and identifying the main actors that could bring about change in the international development architecture.

Chapter 4 starts with a brief account of the interactions between the scenario components, showing the correspondence between different sets of financing instruments and categories of developing countries. It then describes four scenarios for the future of the international development financing system: *Inertia*, *Limited Reforms*, *Major Reforms* and *Transformation*. These scenarios should be seen both as heuristic devices to explore how development financing may evolve over the next decade, and as a projection of the outcomes that may result if certain sequences of critical decisions are taken. *Inertia* corresponds to a 2015 situation similar or slightly worse than the one prevailing at the end of the twentieth century, while *Transformation* describes a situation in which a critical mass of reform efforts have succeeded in making the international development financing system much more effective and efficient. *Limited Reforms* refers to a situation in which minor and piecemeal improvements, focusing exclusively on the poorest countries, are put in place, while in the *Major Reforms* scenario there are significant and visible improvements reaching all types of developing countries, but without their achieving fundamental and sustained aggregate changes for the better.

Chapter 5 derives the policy implications of the four scenarios, articulating them into a framework for strategic choices. Several questions and answers are put forward to assist policy and decision makers in taking stock of the current situation and assessing alternative pathways to reform. Some concluding remarks close the last chapter of the book.

This book is the product of an extended association between the authors, the Institute of Development Studies (IDS) at the University of Sussex and the Ministry for Foreign Affairs of Sweden. It began in 2000 with the preparation of a report on the multilateral development banks as part of the Swedish 'Development Financing 2000' initiative, continued with another study on the provision and financing of global public goods, and culminated with the preparation of the present book as part of the work carried out on Global Development Studies by the Expert Group on Development Initiatives (EGDI) at the Swedish Ministry for Foreign Affairs.

Keith Bezanson, Director of the IDS to July 2004, led the overall project. Francisco Sagasti, Director of Agenda: PERÚ and IDS Senior Associate, was lead researcher and principal author of this report with the collaboration of Fernando Prada as associate researcher. Kristine Blockus and Ursula Casabonne provided research assistance, and Ana Teresa Lima and Joanne Salop contributed research papers on specific issues.

The authors are grateful to Andreas Earshammar, who steered the initial phases of the project, and to Mats Hårsmar and Torgny Holmgren of EGDI, who provided the project team with unflinching support. Valuable comments were received at various stages of the project, especially from the participants in a seminar held in Stockholm in February 2004 to discuss the interim report and a second seminar in the same city in July 2004 to review the draft final version. Additional suggestions were received in presentations in Washington at the World Bank and the International Monetary Fund in November 2004, and in Paris at an event organized by the United Nations Development Programme and the French Ministry for Foreign Affairs in January 2005. The authors are also grateful to Zoe Mars for her help in editing and structuring the book, and to Amanda Hamilton at Palgrave Macmillan for shepherding the manuscript with extraordinary patience.

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1.1 The evolution of the concept of development

The period from the end of the Second World War can be called the 'age of international development'. Initial emphasis on the reconstruction of Europe through the Marshall Plan was quickly transformed into a bold, new political campaign on a global scale. Its stated aim was to make 'the benefits of (Western) scientific advances and industrial progress available for the improvement and growth of underdeveloped areas'.[1]

The idea of development was initially interpreted as being more or less synonymous with economic growth and the early conception of how to bring about development assumed a direct relationship between capital investment and economic growth. The dominant development models of the 1940s and 1950s held that, as developing countries usually had an abundant supply of labour, it was a lack of investment that constrained economic growth and development. This thinking was embodied in the writings of W. Arthur Lewis (1955), for example, who focused attention on investment ratios and insisted on 'growth and not distribution' as the essential path to development. A similar emphasis is found in the works of Walter Rostow (1960) who defined a path to development consisting of five stages of economic growth and in Ragnar Nurske's (1953) theories of massive investment in the urban-industrial sector as essential to capital formation and structural transformation.

During the 1950s and 1960s, therefore, mainstream development theory assigned nearly exclusive importance to finance and investment. Making international finance available was accorded the central