Maximising Finance for Development: Will it Achieve SDGs?

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Recap Investing

Introduction

As the world becomes increasingly connected, developing countries will access foreign finance to fund development investment in critical infrastructure. Due to the extreme disparity between demand for and access to foreign capital, the World Bank and other international development institutions have taken on the role of intermediaries. This has resulted in the opening of Pandora's box of questions and skepticism on who will bear the risks and the political risk associated with large infrastructure projects that are critical to achieving the United Nations' Sustainable Development Goals (SDGs).

SDGs and Infrastructure Financing:

Among the SDGs, Goal 9 (build resilient infrastructure, promote inclusive and sustainable industrialization, and foster innovation) is of particular interest to us in this essay. It should be noted that infrastructure includes more than just highways, airports, and telecommunications, but also a wide range of goods and services such as public housing, improved agricultural supply chains, green energy sources, education, health care, and sanitation.

The economist who proposed the big push theory, Rosenstein-Rodan (1943), articulated the need for massive infrastructure spending for development: "marginal increases in investment in unrelated individual areas of the economy would be like sprinkling here and there a few drops of water in a desert."

Therefore, without significant expenditure on infrastructure, economic growth is doubtful. This has led to a vicious cycle of underdevelopment: the lack of infrastructure resulting in poverty and, therefore, greater political instability and other risks, resulting in a more significant financial gap to fund infrastructure spending.

Savings from the domestic private sector are a significant source of infrastructure financing in a closed economy. Not only is the amount of savings limited, but there are also the larger issues of such projects' long gestation periods, as well as the risks of market failure in the provision of public and quasi-public goods, which make it unattractive to private finance. Expansion of bank credit to the private sector for infrastructure spending entails high risks and the accumulation of non-performing assets, as seen in India's IL&FS crisis.

Increased direct expenditure can also be used to bring infrastructure financing under the purview of the state. This, however, would result in larger budget deficits and higher debt-to-GDP ratios. Furthermore, enormous spending with delayed completion of projects, whether through state funding or even the expansion of bank credit, raises concerns about inflation and exchange rate depreciation from the high import component of infrastructure projects.

The Harrod-Domar Growth model, for example, was built on the concept of state financing of infrastructure, which had influenced the policies of the erstwhile Soviet Union and India's first Five Year Plan.

Foreign Investment and Political Risks

As developing countries turn to Foreign Direct Investment (FDI) for financing large scale projects. They face the same issues of long gestation periods and market failure along with political risks.

According to the Multilateral Investment Guarantee Agency (MIGA), a branch of the World Bank, the following are included within the gambit of political risks: adverse regulatory changes, breach of contract, transfer and convertibility restrictions, non-honouring of government guarantees, expropriation and nationalization as well as a civil disturbance, terrorism and war.

MIGA has carried out studies on mechanisms used by investors to mitigate political risks, which include measures like investing gradually while developing familiarity with the local business environment. Forming a joint venture with local partners, conducting a political and economic risk analysis, and engaging with the host country government and local communities FDI in large infrastructure projects in developing countries, however, is a challenge for both host country stakeholders and investors.

A New Role for the World Bank

The World Bank has decided to act as a financial intermediary for investors instead of a multilateral development bank. To do this the World Bank has adopted the framework called Maximising Finance for Development (MFDs).

The case of Turkey illustrates how the MFD framework provides intermediation between a country lacking the necessary investment finance, coupled with private sector investors who are hesitant to invest in projects that do not yield adequate returns or are at high risk of credit default.

MIGA and the European Bank for Reconstruction and Development (EBRD) developed a risk mitigation scheme ty mitigate liquidity and political risks and delink and decouple project risk from sovereign risk, allowing for higher private sector bond financing and better terms.

The scheme was then applied to an ambitious project in Turkey to build 30 hospital campuses decided by the Ministry of Health. The PPP project was spearheaded by Meridiam, a private sector investment company and tested in the city of Elazig, which had limited access to high-quality healthcare.

MIGA provided US$326 million as political risk insurance as well as protection from the breach of contract expropriation and restrictions on the transfer of foreign exchange for the project. EBRD provided liquidity in two stages: the first being during the construction of the hospital and the second, to help overcome any technical and macroeconomic changes that might spring up in the future.

Meridiam then took on the task of issuing bonds backed by MIGA and EBRD. This ultimately led to a two-fold rise in the Moody ranking of the project to a BAA2 making it a moderate risk investment as compared to Turkey's sovereign ranking of BA1, which is considered high risk. In this way, the intermediation by MFD could give projects access to billions of dollars of private investments shortly.

The Rewa project in Madhya Pradesh, India aimed at improving and scaling up solar power production to meet the requirements of the Paris Agreement is another example of intervention through the MFD framework. Here the WBG provided financial assistance in the form of concessional loans which were divided between a $75 million IBRD loan, a $23 million loan from the Clean Technology Fund (CTF), and a $2 million technical assistance grant from the CTF. The government was tasked with drawing up binding contracts and various other legal agreements with the numerous stakeholders involved, such as State-owned Enterprises (SoEs) and private energy producers, to ensure the project is "investment ready" for bidding by the private sector.

A country such as Afghanistan plagued by chronic political instability has led the WBG and IFC to look at developing the private sector for raisin production, focusing on the Rikweda Fruit Process Company. The IFC provided the company with a US$3 million loan for working capital and advisory services, as well as shouldering various other additional services such as the provision of legal teams and broking negotiations with potential buyers. Meanwhile, MIGA provided US$7.8 million as loan guarantees as well as *"strong and long-term reassurance of business continuity in such a fragile business environment"* thereby giving the industry a better chance of becoming internationally competitive.

Critique of the MFD framework

There is, however, no such thing as a free lunch since many countries have to adopt regulations and conditions to gain access to foreign funds, which might conflict with national interests. The amalgamation of various plans such as the MFDs, the UN's "Billions to Trillions" agenda, and the G20's "Infrastructure as an Asset Class" has resulted in a shift of development financing from the Washington Consensus to Wall Street Consensus (WSC), as articulated by the economist, Daniela Gabor.

The earlier framework – the Washington Consensus – was ensconced within a laissez-faire approach of minimum government maximum governance; nonetheless, direct spending by the state for primary health and education as well as infrastructure projects was accommodated. In the WSC framework, development finance is now primarily about the channelizing trillions of excess savings from the West into development projects while the government of developing countries focus on de-risking projects – from political and economic risks – and, at the same time, facilitate the commodification of infrastructure so that investors can earn a return on capital invested.

However, a paradoxical situation arises if SDGs have to be achieved through the commodification of PPP projects, as this would necessitate the government to charge citizens a fee. In a poor country, the question of affordability arises. To overcome this and simultaneously make the PPP viable, the state may then have to provide a universal basic income (UBI) so that citizens utilise the services. If the income support is inadequate, marginalised communities will remain excluded. This contradicts the very first SDG goal which is to *"end poverty in all its forms everywhere."* Furthermore, the state is also left with the additional costs that it would have borne to hedge against political and economic risks, leaving it with higher fiscal deficits. A further complication arises from the MFD framework. When a UBI cannot be provided, the state must increase economic risk insurance cover to protect investors from demand shortages.

Financial investment sometimes also comes with social conditions. For instance, Bloomberg Barclays MSCI, a financial investment firm conducted bespoke screenings to choose potential investees that have similar social and religious views including anti-abortion regulations and use of contraceptives. This, however, directly contradicted Goal 5 of SDGs: "*Achieve gender equality and empower all women and girls.*"

In her paper, Daniela Gabor also discusses the case of the Azura Powerplant in Nigeria called "Lighting Up Africa". The project was to improve the output of electricity in Nigeria in which the state was responsible for the mitigation of risk involved in the production of electricity by Azura. The distribution of electricity was allotted to the state-owned Nigeria Bulk Electricity Trading, which was already reeling with poor infrastructure and its inability to absorb the energy produced. Finally, they declined to purchase the entire output of electricity produced by Azura. The World Bank intervene and threatened to convert the risk guarantee into a loan. To avoid being left with a dollar-denominated loan, the Central Bank had to forsake funds reserved for other projects. A similar episode also took place in Ghana in which the National Petrol Corporation was obliged under a take it or pay clause to purchase 90% of the output of Sankofa Offshore Gas. This resulted in the government incurring a cost of $500 million, equivalent to 0.7% of Ghana's GDP, and which ended up increasing the fiscal deficit.

While the MFD framework has improved livelihoods in several politically and economically unstable regions across the world, there remains a conflict of interest between governments and those expecting returns with minimal risk. These contradictions are likely to play out over time.

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