Public Disclosure Authorized

THE WORLD BANK

POVERTY REDUCTION AND ECONOMIC MANAGEMENT NETWORK (PREM)

Economic Premise

78974

JUNE 2013 • Number 121

Investment Financing in the Wake of the Crisis: The Role of Multilateral Development Banks

Jeff Chelsky, Claire Morel, and Mabruk Kabir

Public Disclosure Authorized

Sustained growth in emerging markets and developing economies requires long-term, reliable capital to finance productive investment, including in basic infrastructure. However, the availability and composition of long-term financing is constrained, partly due to fragile market conditions and cyclical weaknesses in parts of the global economy, as well as longer-term trends. This has had a particularly negative impact on developing economies that do not have reliable access to international bond markets and on sectors that have traditionally relied on bank lending (such as infrastructure). At the same time, fiscal space has been eroded by the crisis, and the direct lending capacity of multilateral development banks remains constrained. This heightens the importance of the catalytic role of the official sector in mobilizing long-term financing from the private sector by drawing on its ability to reduce and share risk. This note[1] explores some of the ways in which MDBs are equipped to serve this purpose.

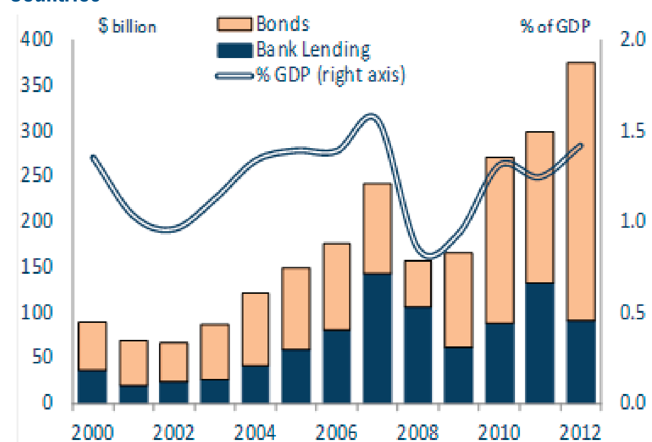
At their June 2012 Summit in Los Cabos, Mexico, G20 leaders pledged to "intensify efforts to create a more conducive environment for development, including supporting infrastructure investment."[2] This focus grew out of concern that fragile market conditions in the wake of the global financial crisis were constraining the availability of long-term financing, particularly the type needed to support productivity-enhancing investment for sustainable growth.

By some estimates, developing countries will need to invest an estimated additional US$1 trillion per annum through 2020 to keep pace with the demands of rapid urbanization, growth, climate change, and the push for greater global integration and connectivity. While such estimates are inherently assumption driven and influenced by the effectiveness and efficiency with which available resources are used, they still reflect the underlying fact that needs vastly outstrip available long-term financing. This is particularly true for infrastructure financing.

Postcrisis Blues: The Long-Term Investment Financing Landscape

Over the past decade, emerging markets and developing economies (EMDEs) have made notable progress in accessing international capital markets. International long-term debt flows to developing countries (defined here as bonds and syndicated bank lending with at least five years of maturity) increased fourfold in nominal terms from 2000 to 2012 (figure 1). However, progress has not been steady. The global financial crisis resulted in a protracted retrenchment in global bank lending, and a sharp but temporary contraction in long-term international debt flows.

Figure 1. International Long-Term Private Debt to Developing Countries



Source: Dealogic and The World Bank.

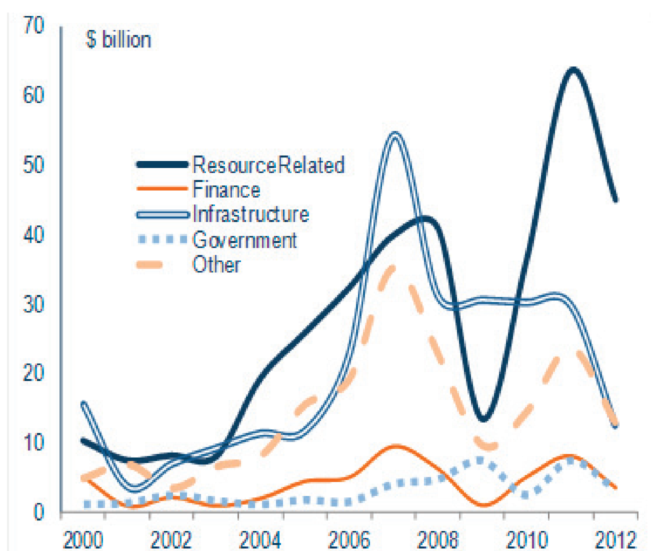
A diagnostic assessment prepared for the G20 finance ministers and central bank governors in February (G20 2013) noted that all major categories of long-term financing—debt flows, bank lending, bonds, portfolio equity, and foreign direct investment—have been affected by the crisis, but to different degrees and in different ways. Since most EMDEs do not have stable access to all types of financing, and different types of financing are not perfect substitutes for one another, this change in composition has impacted some sectors more than others. In the infrastructure sector, for example, bank and bond financing are not perfect substitutes. Banks play a particularly significant role in the complex financing of the early stages of infrastructure projects. This is a concern, because long-term syndicated bank lending to EMDEs fell sharply in the aftermath of the financial crisis, resulting in a 26 percent fall in 2008, followed by 41 percent decline in 2009. Lending has remained weak ever since (figure 2).

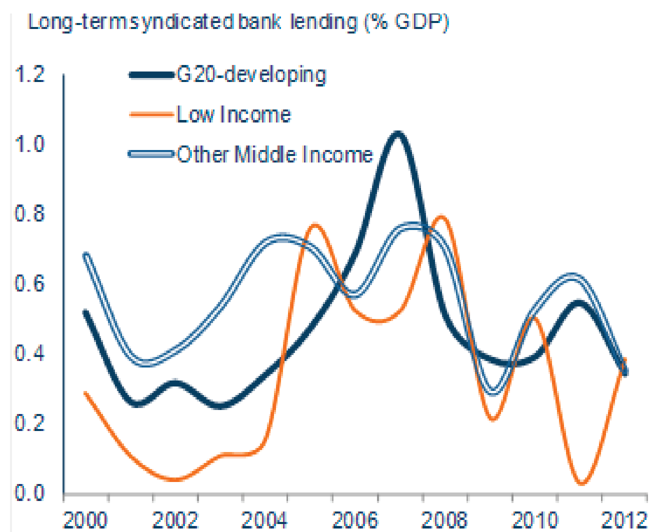
Much of the weakness can be explained by stresses in European banks, which were frequent deal participants in the syndicated loan market, particularly with EMDEs, with market shares typically higher than 80 percent. The volume of deals involving European banks dropped significantly in 2007, 2008, and 2011, when bank stress soared. Other banks took advantage of receding European banks, but while the volume of deals without European banks increased, other banks did not fully fill the gap, particularly in highly specialized types of financing (such as infrastructure).

Bond flows fared better and rebounded after the crisis, more than offsetting the reduction in bank lending. This was partly the result of policy-induced low interest rates and quantitative easing in high-income countries, which prompted a search for yield by global investors. International bond flows to developing countries with maturities of at least five years have increased steadily since 2009, as conditions for bond financing have become particularly favorable for many developing countries.

However, while bond issuance increased sharply in EMDEs after the crisis, the rise was concentrated mainly in Latin American and emerging Europe. Rather than financing new economic activity, much of this bond issuance resulted from efforts to refinance existing debt at lower interest rates or to refinance syndicated lending that was not being rolled over. Low-income countries, often lacking access to international bond markets, fared relatively poorly, receiving less than 0.5 percent of their gross domestic prod-

Figure 2. Long-Term Syndicated Bank Lending Declined Sharply in All Developing Countries and All Sectors





Source: Dealogic and World Bank.

uct (GDP), down from precrisis peaks of nearly 0.8 percent (but well above the level of the early 2000s).

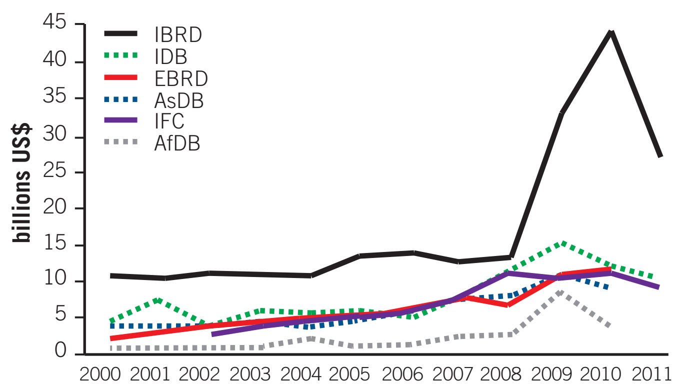
Bridging the Gap for Long-Term Financing: Multilateral Development Banks as Catalysts

Undoubtably, the global financial crisis has strained traditional sources of long-term financing, particularly for infrastructure. Government budgets—a major source of infrastructure financing—are overstretched, leaving little room for additional spending. Financial fragility and the urgency to rebuild balance sheets has significantly constrained the ability of the private sector to provide long-term financing, or reduced their risk tolerance and lending horizon. Banks, particularly European banks, which have traditionally played a leading role in structured finance, are still recovering from the crisis and adjusting to tighter regulatory requirements.

Developing-country capital markets generally lack the depth and breadth to provide the type of long-term financing required for infrastructure. At the same time, heightened uncertainty has translated into large pools of liquidity sitting relatively idle with few financial intermediaries to deploy them into infrastructure. This reality—and the overarching need to foster strong, sustainable, and balanced global growth—calls for greater attention to policies and instruments that can lower risk and strengthen the confidence of investors over a long-term horizon.

Even in normal times, private financing for socially productive investments (including public goods) is often insufficient, if not entirely unavailable, without official sector involvement. The reluctance of private sector agents to provide financing is often due to market failures, such as problems arising from asymmetric information. Additional constraints stem from lack of investor experience with particular types of investments, economic activities (for example, infrastructure), or countries. Attracting private finance sometimes requires closing the financial viability gap (that is, between costs and expected revenues), using public resources complemented by legislative and institutional improvements to catalyze private financing.

Figure 3. Nonconcessional Financing from MDBs



Source: Congressional Research Service, using data from MDBs' annual reports.

Official sector entities such as multilateral development banks (MDBs) can play a useful catalytic and countercyclical role, helping to share risk with private investors to enhance the viability of investments and sustain productive investment when private finance becomes scarce. Figure 3 illustrates the extent to which MDBs, particularly the World Bank, were able to ramp up lending volumes in the wake of the global financial crisis.

How Do MDBs Achieve Additionality?

MDBs can help their clients attract additional financing from the private sector through a combination of a strong financial position; preferred creditor status; technical expertise; prudent risk management policies; credible application of well understood standards in project design, execution, and corporate governance; a long-term perspective; and cross-country experience. Indeed, in a world of competing demands and scarce public resources, MDBs are increasingly being called on to demonstrate the value added of their engagement. Buiter and Fries (2002) illustrate a useful framework identifying several types of potential "additionality."

According to their framework, MDBs can contribute their own funding and help build the confidence necessary to attract commercial funding through a wide range of financing and mobilization instruments. MDBs achieve this **financial additionality** in many ways, with varying degrees of engagement. The most direct demonstration of financial additionality (sometimes referred to as the "core" catalytic role) involves actively bringing financing partners into specific deals, for example, through syndications or cofinancing arrangements. In some cases, this can provide partners with a level of creditor status comparable to that of official creditors, in the event that the borrower runs into repayment difficulty. Box 1 highlights a few instruments used by MDBs to mobilize resources.

The impact of official-sector engagement goes beyond direct financing and core catalytic resource mobilization. Gaps between investment needs and the availability of appropriate financing often arise not only from the supply side of financing, but also as the result of a weak underlying investment climate, lack of planning and institutional capacity, and the absence of strong regulatory frameworks.[3]

MDBs catalyze financial resources from other sources through what Buiter and Fries call **design additionality**. This contribution derives from the technical expertise that MDBs can bring to projects to improve their "bankability," or attractiveness, to private sector investors, and can occur through promoting efficiency, transparency, and adherence to accepted standards in project design, including environmental standards. As facilitators of knowledge, capacity

building, and peer learning, MDBs can assist countries in improving project management and supporting institutional capacity. By bringing enhanced transparency, sound practices, and internationally accepted standards to projects, these interventions address certain information asymmetries faced by potential investors, helping to reduce risk and attract investment.

Policy additionality can derive from the support that MDBs provide to improve the policy and regulatory environment for investment and to mitigate the risk of significant policy reversals. MDB policy-based lending can contribute to enhancement of the environment for productive investment at the macro- or sectoral level, thereby helping to attract additional financing, particularly from the private sector. A considerable part of the impact of official engagement on the mobilization of long-term financing derives from the advisory services and technical assistance provided to borrowers. This type of support can improve the investment climate, including competition policy, consumer protection, property and creditor rights, trade facilitation, judicial reform, budget and debt management capacity building, or market reforms. Buiter and Fries note that MDBs have unique characteristics, related to the design and implementation of structural reforms and institution-building programs adopted by governments, that afford them a comparative advantage in providing finance. Moreover, MDBs generally enjoy greater access to policy makers than do their private counterparts, and commitments made to MDBs are less likely to be reversed due to the longer-term relationships that MDBs maintain with their clients. This suggests that MDB engagement can have the biggest impact in sectors where the returns to private investment are strongly dependent on government policies and practices.

Demonstration additionality refers to the potential for projects supported by official sector entities to illustrate the possibilities of success (for example, by improving private sector perceptions of the risk-return trade-off for certain types of investments). The greatest potential lies in frontier markets and innovative, riskier sectors and technologies. Buiter and Fries argue that this form of additionality is particularly valuable in economies where "businesses are often more focused on seeking rents than on undertaking the innovation and investment that is necessary to exploit newly created profit opportunities and to expand." However, as Spratt and Collins (2012) note, when projects fail, the "demonstration" effect can also undermine subsequent private sector engagement.

Selection additionality, while not part of the Buiter and Fries framework, could be considered a fifth form of additionality: the support provided by official entities when they encourage better project selection by governments. Because of their governance and accountability structures, many MDBs systematically require clear demonstration of impact in the projects they agree to support. This helps to identify, prioritize, and mobilize financing for investments with the highest payoff in terms of growth and development, and can mitigate undue political influence in the selection of projects to be supported.

Box 1. MDB Instruments to Mobilize Resources

Investment and project loans. MDBs have a comparative advantage in meeting long-term investment financing needs and mobilizing long-term foreign and local currency financing at more affordable rates. While MDBs do lend at interest rates that adequately reflect risks, they generally offer relatively longer maturities and grace periods than the private sector, and are sometimes the only entities willing and able to provide financing with the appropriate maturity. With high credit ratings—since backing by shareholder governments can reduce, if not eliminate, default risk—and higher levels of liquidity, MDBs can often hold riskier portfolios than private investors, enabling them to intervene where private actors would be reticent to act. Between 2000 and 2013, on average, investment and project lending accounted for 75 percent of African Development Bank (AfDB) lending, 76 percent of Asian Development Bank (AsDB) lending, 79 percent of Inter-American Development Bank (IDB) lending, and 64 percent of International Bank for Reconstruction and Development (IBRD) lending.

Equity investments. Many MDBs also have mandates to engage directly with the private sector, rather than exclusively through governments. This allows the MDBs to purchase equity in firms in strategic or catalytic sectors. In addition to direct equity finance, MDB participation is often augmented through representation on corporate boards and by knowledge of global good practices, including sound corporate governance standards. This in turn can provide a higher degree of comfort to other investors, encouraging them to also purchase equity in those firms. The International Finance Corporation (IFC), the European Bank for Reconstruction and Development (EBRD), and the AsDB have been the most engaged in the direct provision of equity finance. Certain official sector entities also promote equity investments by supporting private equity funds, such as the IFC through its Asset Management Corporation.

Risk mitigation: guarantees. Official entities like MDBs also have an edge over the private sector because their official status and financial structures enable them to absorb more risk—both default risk and political interference risk—making them particularly useful in the early stages of a deal. MDBs frequently play an important role in drawing private capital into long-term projects in destinations where the market perceives high risks associated with inexperienced institutions and regulatory and judicial weakness. MDB risk mitigation arms provide coverage projects that, although financially and economically viable, would have been challenging without protection against noncommercial risks.

Source: Authors' compilation.

Looking Ahead: G20 Work Plan on Long-Term Investment Financing

Recognizing the essential role that long-term financing plays in supporting the goal of strong, sustainable and balanced growth, G20 finance ministers and central bank governors agreed at their meeting in Moscow in February 2013 to establish a Study Group on Financing for Investment, which will work closely with the World Bank Group, the Organisation for Economic Co-operation and Development (OECD), the International Monetary Fund (IMF), Financial Stability Board (FSB), the United Nations (UN), the United Nations Conference on Trade and Development (UNCTAD), and other relevant international organizations to consider issues raised in the diagnostic Umbrella Report and determine a work plan for the G20. The Presidency of the G20 asked Germany and Indonesia to cochair the study group, which was set up in March 2013.

The study group adopted a work program that focuses on five key topics:

i. **country-specific factors** that influence a country's ability to attract long-term financing;
ii. c**apital markets**, highlighting the role of domestic capital markets, including local currency bond markets, in mobilizing resources;
iii. **private sources of financing** that could be a viable source of long-term financing, including for infrastructure;
iv. **official sources of financing**, focusing on actors catalyzing long-term financing from other sources; and
v. **global financial regulatory reform**, and the extent to which it may impact the availability of long-term financing.

To support the study group, the World Bank Group is leading and/or participating in several of these work streams, the results of which should be available within the next 6 to 12 months. The World Bank Group will be pursuing work on the following topics, among others:

i. enhancing the catalytic role of the World Bank Group in mobilizing financing;
ii. improving the quality of infrastructure project section, design, and management in EMDEs as a catalyst for mobilizing private sector financing;
iii. developing domestic capital markets as a source of long-term financing;
iv. identifying practical approaches for mobilizing institutional investment in infrastructure in EMDEs;
v. discussing the challenges involved in using sovereign wealth funds for domestic investment; and
vi. assessing the impact of regulatory reform on long-term financing in EMDEs.

This work, in addition to furthering the World Bank Group's fulfillment of its development mandate, will inform G20 discussions of the challenges faced in mobilizing long-term financing in support of achieving strong, sustainable, and balanced growth.

About the Authors

Jeff Chelsky is the *Lead Economist* and *Coordinator, International Policy and Partnerships Group* at the *Poverty Reduction and Economic Management Network* of the *World Bank. Claire Morel* is a *Consultant* in the *International Policy and Partnerships Group* at the *Poverty Reduction and Economic Management Network. Mabruk Kabir* is a *Consultant* at the *Poverty Reduction and Economic Management Network.*

Notes

1. This note draws on Chelsky and Morel (2013).
2. "G20 Leaders' Declaration," Los Cabos, Mexico, June 19, 2012, http://www.g20.utoronto.ca/2012/2012-0619-loscabos.html.
3. See, for example, World Bank (2012).

References

Buiter, W., and S. Fries. 2002. "What Should the Multilateral Development Banks Do?" Working Paper No. 74, European Bank for Reconstruction and Development.

Chelsky, Jeff, and Claire Morel. 2013. "Official-Sector Non-Concessional Long-Term Financing: The Role of Multilateral Development Banks." Issue Note prepared for the World Bank's (2013) "Long-Term Investment Financing for Growth and Development: Umbrella Paper."

G20 (Group of 20). 2013. "Long-Term Investment Financing for Growth and Development: Umbrella Paper." Presented to the Meeting of the G20 Ministers of Finance and Central Bank Governors, February, Moscow, Russian Federation. Prepared by World Bank staff based on input from the staffs of the Organization for Economic Co-operation and Development, International Monetary Fund, United Nations Conference on Trade and Development, United Nations Department of Economic and Social Affairs, the World Bank Group, and Financial Stability Board. http://www.g20.org/news/20130228/781245645.html.

Spratt, Stephen, and Lily Ryan Collins. 2012. "Development Finance Institutions and Infrastructure: A Systematic Review of Evidence for Development Additionality." Institute of Development Studies and Engineers against Poverty, January.

World Bank. 2012. "Restoring and Sustaining Growth." Prepared by the staff of the World Bank Group for G20 Finance Ministers and Central Bank Governors, June.

The *Economic Premise* note series is intended to summarize good practices and key policy findings on topics related to economic policy. They are produced by the Poverty Reduction and Economic Management (PREM) Network Vice-Presidency of the World Bank. The views expressed here are those of the authors and do not necessarily reflect those of the World Bank. The notes are available at: www.worldbank.org/economicpremise.