

# TRADE AND DEVELOPMENT REPORT, 2015

Making the international financial  
architecture work for development

## *Chapter VI*

### LONG-TERM INTERNATIONAL FINANCE FOR DEVELOPMENT: CHALLENGES AND POSSIBILITIES



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**Chapter VI**

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## LONG-TERM INTERNATIONAL FINANCE FOR DEVELOPMENT: CHALLENGES AND POSSIBILITIES

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### A. Introduction

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A concern that has emerged repeatedly in the previous chapters is the apparent inability of the current global monetary and financial systems to make available long-term finance for growth and development. This chapter considers some of the possible strategies for ensuring the provision of such finance. The focus is on the financing of productive capital formation, including for infrastructure, which helps, directly and indirectly, to accelerate growth and structural change. This effectively requires challenging the rationale underlying private financial flows that are driven by short-term profits and rents, and strengthening mechanisms for mobilizing and allocating both domestic and external finance for value creation and development over a longer time horizon. While domestic resources (both private and public) are likely to remain the most important (*TDRs 2008* and *2013*), international finance can play an important role when domestic funding is not available or is insufficient, particularly when a country is in need of foreign exchange to import capital goods and production inputs beyond what it earns through its exports of goods and services.

It is well known that private financial markets cannot be relied upon to fully fund long-term investment projects. This is because associated investments typically involve longer gestation periods and entail greater risk and uncertainty about eventual outcomes,

even while they create significant positive externalities for the rest of the economy and complementary investment projects. These factors generate differences between private profitability and social returns on such investment. It is also recognized that private financial markets, left to themselves, seldom direct finance to such classes of borrowers as small and medium-sized enterprises (SMEs) or start-ups, or to activities whose returns are not immediately evident and cannot be readily calculated. This negatively affects activities that could be crucial for future growth and which could produce considerable social benefits, such as innovation, technological progress and environmental protection. These features are equally characteristic of global financial markets. Thus, greater financial integration of developing countries has not delivered on expectations of easier access to the kind of long-term financing needed to boost growth and development. Consequently, there appears to be a need for State action to ensure the provision of both external and domestic long-term finance for these purposes.

The nature of such State involvement can vary according to the types of activities that are to be funded. Financing for purely public goods necessarily requires appropriate public domestic revenues, and in the context of external financing this is most likely to be supported by official development assistance

(ODA) or other forms of development cooperation. In the case of merit goods and services, as well as other activities with large positive externalities, a mix of public and private arrangements is conceivable, typically involving some degree of explicit or implicit government subsidies, which in turn would require either internal or external resources, usually channelled through the public coffers. Recent initiatives based on public-private partnerships (PPPs) are one possible response. Finally, there are some activities that generate changes in productive structures and are potentially profitable (such as some kinds of infrastructure investment), which are nevertheless avoided by private investors because of uncertainties associated with lumpy investment requirements with large initial costs, long gestation periods and associated risks. These call for a greater role by financial institutions that are specifically geared to making such long-term investments, such as development banks.

In this chapter, each of these types of external financing for long-term development is considered in turn. In section B, it is argued that, while official financing has increased in the past decade, it is still

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Financing productive capital formation requires challenging the rationale underlying private financial flows that are driven by short-term profits and rents.

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well below desired levels, and there remain some concerns about its effectiveness and conditionalities sometimes incorporated in ODA. As a result, some developing countries seeking long-term external finance for development purposes have resorted to other arrangements, most notably through a greater emphasis on programmes and projects that involve PPPs, as examined in section C. However, while these provide opportunities to involve private firms

in infrastructure investment, there are also risks associated with them, particularly in terms of fiscal costs, which can be much greater than anticipated and may extend over a very long time horizon. Section D examines the role of sovereign wealth funds. Some of them control significant amounts of capital, and could conceivably play an important role in providing

some long-term development finance; but, thus far, their involvement in this area has been extremely limited. Section E analyses the use of national, regional and interregional development banks, which remain an effective option for mobilizing long-term finance. Recent new initiatives in this area are encouraging, but will need to be scaled up substantially to meet current and future development goals.

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## B. Financing through official cooperation

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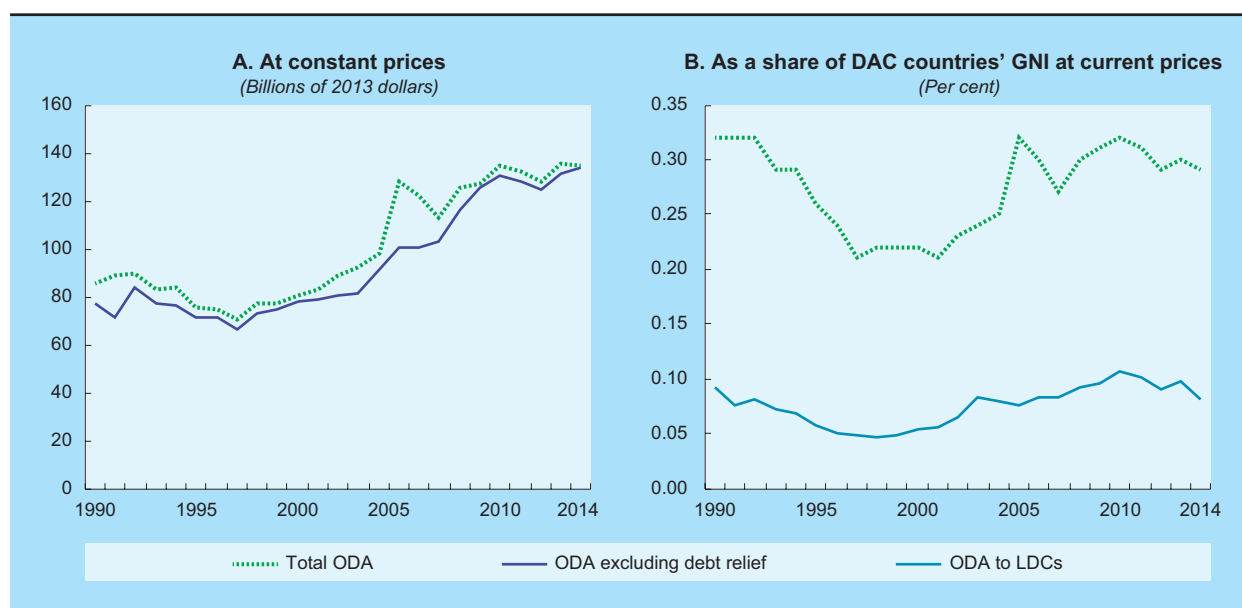
Official development financing refers to expenditures directed at strengthening productive capacities, promoting structural change and enhancing social well-being in recipient countries. It does not include humanitarian or military aid of various types. It involves the provision of either grants or loans, which can be delivered bilaterally or channelled through multilateral agencies and non-governmental organizations (NGOs). Grants do not require repayment, whereas loans are extended with some element of subsidy but must be repaid, and

therefore imply a return to the donor in some form. This distinction is important to note, because different forms of development-related expenditures have different effects on countries' debt-servicing capacities, and therefore the use of loans that are part of development assistance should generate the income needed to repay the debt.

Official financing has traditionally been seen as a flow from developed countries to the developing ones, particularly the poorest countries. However,

Chart 6.1

## ODA PROVIDED BY DAC COUNTRIES, 1990–2014



**Source:** UNCTAD secretariat calculations, based on *OECD.stat* database.

recent trends indicate the growing importance of emerging developing countries as donors, although they provide different forms of development cooperation and assistance than the more traditional donors.

### 1. Official development assistance from developed countries

What is currently known as official development assistance is a subset of external official aid provided by developed to developing countries. The need for establishing a stable flow of ODA was already debated in the 1950s and 1960s. Negotiations within the United Nations system eventually led to developed countries committing to an annual transfer of at least 0.7 per cent of their gross national income (GNI) as foreign aid to developing countries.<sup>1</sup>

Following a period of decline and stagnation in the 1990s, registered ODA flows to developing countries increased significantly in the 2000s (chart 6.1A). Net disbursements by members of the Development Assistance Committee (DAC) of the Organisation for

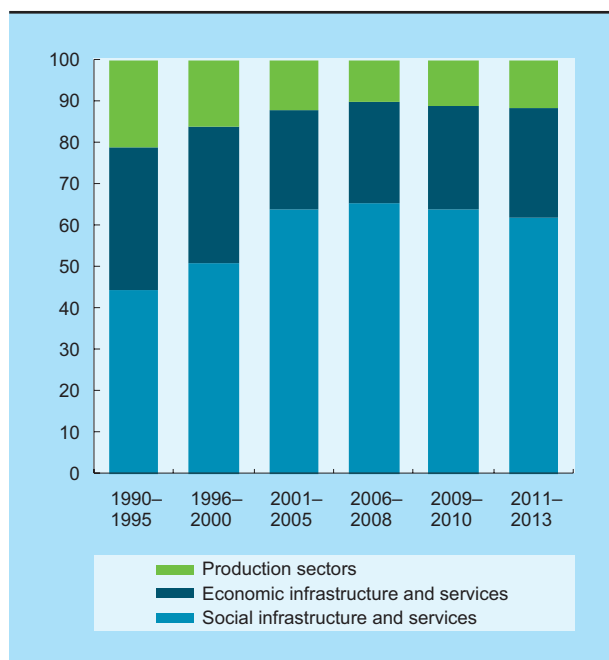
Economic Co-operation and Development (OECD) rose from \$89 billion in 2002 to \$134 billion in 2014 (in constant 2013 dollar terms) – a 51 per cent increase, though an amount slightly below the record levels in 2010 and 2013. However, this still represents only 0.29 per cent of their GNI, which is far short of their committed target of 0.7 per cent of GNI and is lower than the shares in the early 1990s.<sup>2</sup> Moreover, this percentage has been on a declining trend since 2010, both for total ODA and for ODA to the least developed countries (LDCs) (chart 6.1B). Around one third of ODA has been directed towards LDCs, where, on average, it accounts for over 70 per cent of external financing (United Nations, 2014a). In constant dollar terms, it more than doubled between 2000 and 2010, but it has been falling in recent years. Indeed, bilateral aid to LDCs declined by 16 per cent in 2014 (OECD, 2015). Moreover, spending plans by major donors suggest that there is unlikely to be a significant growth of ODA flows in the medium term (OECD, 2014a).

A growing proportion of OECD-DAC assistance has been directed to the social sector – partly as a consequence of the efforts towards achieving the Millennium Development Goals. ODA to this

Chart 6.2

### COMPOSITION OF DEVELOPMENTAL ODA BY MAIN CATEGORIES, 1990–2013

(Per cent)



Source: UNCTAD secretariat calculations, based on *OECD.stat* database.

sector increased by 117 per cent (in constant dollars) between 2000 and 2008. A similar increase was recorded for ODA to economic infrastructure and the services sector, while aid to the production sector registered a smaller increase of 78 per cent. Viewed from another perspective, the share of ODA oriented to the social sector in total developmental aid<sup>3</sup> increased from less than 50 per cent in the 1990s to over 60 per cent in 2008, and has remained relatively stable since then. Conversely, the share of ODA flows to economic infrastructure and the services sector, as well as to the production sectors, declined (chart 6.2).

The effectiveness of ODA<sup>4</sup> in supporting development varies considerably depending on its modalities, whether it consists of grants or loans, whether it is delivered bilaterally or through multilateral agencies and whether it takes the form of budget support (not earmarked for any specific purpose) or project financing. Donor countries generally prefer project financing through bilateral procedures because they can better control the use of the funds,

including by tying their delivery to the procurement of goods and services produced by the companies of the donor country. It has been estimated that tied aid raises the cost of goods and services, and reduces the potential for local development.<sup>5</sup> Multilateral aid and budget support are in general better options for recipients because they reduce the possibility of donor preferences exerting distorting influences, and therefore increase the ownership of aid by the recipient country. They may also help to improve predictability, coherence, transparency and accountability of aid (UNCTAD, 2006). Multilateral aid represented 39 per cent of total ODA in 2011–2012 (OECD, 2014b). Also, aid provided on a multi-year basis is more predictable for the recipient; when it is unpredictable and volatile, the value of aid can fall by as much as 15–20 per cent.<sup>6</sup>

Besides the modality of ODA, the nature of some of its components also influences its effectiveness. Indeed, some of the flows included in the OECD-DAC definition provide only limited development aid. For instance, for many years some credit delivered at market interest rates could be registered as ODA even though it did not really reflect a donor effort, just because the reference interest rate of 10 per cent was excessively high. Other components of ODA do not imply a transfer of resources to developing countries, such as in-donor expenditures, including technical assistance, administrative costs, costs of educating foreign students and costs of hosting refugees (Charnoz and Severino, 2015). Moreover, debt relief is included as a significant element of ODA, even in cases where it has little or no impact in terms of net financial flows (see chart 6.1A). Some loans might even be counted twice as ODA: when they are delivered, and again when they are cancelled. According to ActionAid (2005), in 2003 only 39 per cent of ODA was “real aid”.<sup>7</sup>

OECD-DAC has responded to this criticism by distinguishing between total ODA and country programmable aid (CPA), also known as core aid. CPA excludes from bilateral ODA those activities that are inherently unpredictable (such as humanitarian aid and debt relief), that do not involve cross-border flows, and that are not part of agreements between governments (OECD, 2014a). It is estimated that between 2009 and 2013 CPA accounted for 57 per cent of gross bilateral ODA. However, total ODA remained the target in DAC countries’ commitments. Furthermore, in December 2014 the OECD-DAC

High-Level Meeting decided to revise the definition and measurement of ODA in order to “modernize” it (OECD, 2014c). The main change relates to the way in which concessional loans are reported as ODA.

Since the turn of the millennium, the international community has progressively focused on improving the way aid is delivered. This indicates a growing recognition that it is not only the volume of ODA that matters; the quality of ODA is also critical for maximizing its development impact.<sup>8</sup> This has led to the development of a number of principles for improving aid effectiveness, including ownership of national development strategies, alignment of donors to those strategies, harmonization among donors, a focus on results, mutual accountability and transparency. It has also resulted in periodic assessments of the evolution of ODA. An assessment of development effectiveness made in 2010 indicated that there had been very slow progress in meeting most of the targets set in the Paris Declaration (UNCTAD, 2011a). The Busan Partnership agreement in 2011 resulted in the establishment of the Global Partnership for Effective Development Co-operation, which held its first High-Level Meeting in Mexico in 2014. The assessment of progress on aid effectiveness prepared for this meeting showed that the results were mixed (OECD and UNDP, 2014).

## 2. Development cooperation among developing countries

A potentially important new trend in global development assistance is the growing significance of developing-country donors. According to the United Nations (2014b), in 2011 the total value of South-South cooperation was estimated at between \$16.1 billion and \$19 billion, and its share in total development cooperation was 10 per cent in 2011, up from 6.7 per cent in 2006. However, this may well be an underestimate, especially as definitions of development assistance vary, and there are no systematic and comparable data across countries. For many developing countries, development cooperation is closely linked to trade

and investment relationships, and it is often hard to distinguish between public and private components (Zhou, 2010).

One study has suggested that South-South financial assistance represented around 15 per cent of DAC real aid in 2008, with the largest developing-country donors that year being Saudi Arabia, China, the Bolivarian Republic of Venezuela, the Republic of Korea, Turkey and India, though in other years Brazil has also been a significant donor (The Reality of Aid Management Committee, 2010). Since then, the amount of financial assistance has grown substantially, led by China. It should be noted that not all of this financial assistance would qualify as ODA in the sense used by DAC members. Financial assistance from non-DAC countries has taken the form of grants, concessional loans, non-concessional loans and debt relief. The mix of financial assistance varies from country to country, but loans are the predominant form.

Official Chinese sources explicitly distinguish between three categories of financial assistance: grants, interest-free loans and concessional loans. The first two are funded directly by the government exchequer, while the third is funded by the Exim Bank of China (see section E). A large proportion is tied aid, which requires that at least half the purchases made under the assistance programmes be for Chinese goods, and, in several cases, for Chinese labour as well. Nevertheless, since a substantial proportion of such Chinese assistance is directed towards infrastructure development, it can contribute significantly to transforming productive capacities over the medium and long term. Wolf et al. (2013) estimate that, during the period 2001–2011, Latin America received the largest amount of such

Chinese assistance (much of it for a multi-country programme oriented to natural resources), followed by Africa (a mix of natural resource and infrastructure programmes), South Asia (infrastructure and financial aid for budgetary support) and South-East Asia (mostly infrastructure).

Indian financial assistance takes the form of credit, concessional loans and grants. It has been used to finance infrastructure development (e.g. railway

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A potentially important new trend in global development assistance is the growing significance of developing-country donors.

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reconstruction in Angola), the purchase of agricultural machinery and equipment, development of information and communications technologies (ICTs), the setting up of processing companies (cashew nuts in the United Republic of Tanzania) and for health and humanitarian purposes. Most of it is provided by the India Export-Import Bank. The Republic of Korea and Saudi Arabia provide grants and concessional loans. Assistance by the former supports health, ICT, education and agriculture. Through the Petroamérica Project launched in 2005, the Bolivarian Republic of Venezuela has been providing oil under very favourable financial conditions to Latin American and Caribbean countries (*TDR 2007*). A number of West Asian countries provide assistance to productive sectors (e.g. transportation, telecommunications, energy and agriculture). Most of their funding comes from their finance ministries and a small portion from the Saudi Fund for Development, in addition to assistance provided through multilateral channels. Turkey's assistance takes the form of grants, export credits and loans to support the education and health sectors, and the development of water resources, infrastructure, agriculture and culture (Kragelund, 2008).

Brazil can be singled out as the country in which co-financing is the most prevalent form of assistance, delivered trilaterally with the involvement of its own government agency, a host government agency and a developed-country donor (Kragelund, 2008; UNCTAD, 2010); it has targeted in particular the agriculture, education, health and fisheries sectors, as well as reconstruction (Gottschalk et al., 2011). Also, its national development bank has provided an increasing number of loans, particularly for large infrastructure projects in Africa and Latin America.

### 3. Challenges of official cooperation

Proponents of increased aid agree that, while it is not a panacea or engine of growth, it can work as a catalyst for development, for example by supporting infrastructure development. Sceptics of aid, on the other hand, point to various downside risks, such as limited absorptive capacities of some recipient countries, Dutch-disease effects, crowding out of other sources of finance, reduction of fiscal efforts and corruption. However, some of these concerns

are often exaggerated (UNCTAD, 2006), and others can be resolved by proper aid management and macroeconomic policies, as well as through appropriate procedures for accountability and monitoring. The conditionalities associated with aid are clearly important in this respect, and can have either positive or negative effects depending upon their terms and how they are implemented.

Since the Monterrey Consensus of 2002, which emphasized the need for increasing ODA as a precondition for achieving the Millennium Development Goals, there have been some improvements in the management of aid flows. These include efforts to untie aid, reporting of ODA in national budgets of recipient countries and the use of country administrative systems in the management of aid-funded programmes and projects (United Nations, 2014b). For instance, in 2012, 79 per cent of DAC bilateral ODA was reported as untied, up from about 50 per cent at the start of the millennium (OECD and UNDP, 2014).<sup>9</sup> However, “conditions attached to ODA remain too numerous and detailed in some cases, (and) procedures remain complex and insufficiently flexible”. Moreover, fragmentation of aid remains high, and is increasing, with emerging donors and actors, which poses significant coordination challenges (United Nations, 2014b: 8). Most of all, despite recent increases, this type of long-term development financing still remains well below both commitments and requirements.

An important area of official financing that has remained relatively neglected relates to the financing of programmes for global public goods. This is particularly evident in the areas of climate change mitigation and adaptation. Major global agreements on climate change have stressed the need for climate finance to be “new and additional”. Under the Copenhagen Accord, developed countries collectively committed to provide “fast start” finance of about \$30 billion for the period 2010–2012, with a balanced allocation between adaptation and mitigation. They also committed to the goal of jointly mobilizing \$100 billion a year by 2020 to address the needs of developing countries (UNFCCC, 2009). An assessment of fast-start finance between 2010 and 2012 found that \$35 billion was mobilized in this period. However, 80 per cent of these resources were estimated to have also been counted as ODA (Nakhouda et al., 2013). Pledges made by donors to mobilize \$10.2 billion (UNFCCC, 2014) represent an



important step to operationalizing the United Nations Green Climate Fund, although they only amount to about 10 per cent of the committed target for 2020.

Since there appears to be no proper definition of what “new and additional” means, nor any internationally agreed definition of climate finance and how it is to be delivered, “much climate finance is currently sourced from existing aid commitments and flows through a decentralized system dominated by a large number of bilateral aid agencies and a series of multi-lateral funds” (Pickering et al., 2015:149). Therefore much of the climate finance has not been additional, and has also made the aid fragmentation problem more complex. Further, the aid provided thus far has been mainly directed to mitigation efforts, which disproportionately benefit middle-income developing countries. Financing for adaptation purposes, which is crucial for the poorest countries, remains inadequate (UN-DESA, 2015; Nakhooda et al., 2013). This makes a strong case for a greater focus on official financing by the richer countries – and other countries in a position to do so – for climate change mitigation and adaptation in the poorer countries.

In recognition of the relatively small amount of official financing that is currently available, there are ongoing discussions on the potential use of “blended finance”, in which ODA would be used to “leverage” private capital for long-term investment. For example, ODA could provide subsidies on loans and equity investments, or guarantees to private investors or for co-financing arrangements. This approach of using aid as a lever to attract private finance is already part of the external assistance programmes of several developing countries, including China, as noted above. It is also now being encouraged by other donors, and is strongly promoted by international organizations such as the World Bank and the OECD.<sup>10</sup>

In a sense, since development-oriented investment necessarily generates externalities and complementarities between the public and private sectors, and effective investment finance mixes public

and private initiatives, all development finance is blended; the greater issue is to address who is doing the blending, how and to what end. Such initiatives may have advantages in terms of increasing resource mobilization,<sup>11</sup> but also have some drawbacks, as highlighted in recent research.<sup>12</sup> In particular,

they risk allowing ODA flows to reinforce the inequalities that private markets generate in terms of geographical, sectoral and institutional coverage. Aid that is linked to expanding investment by the private sector is more likely to go to middle-income countries and bypass

the low-income countries. Furthermore, there is typically inadequate support for SMEs in developing countries. Many attempts to utilize ODA to support private investment do not adequately capture the diversity in the private sector; for example, they do not always take into account the difference between development-oriented spending to support small farmers with input purchases and investments in developing countries by transnational corporations (TNCs) that are simply seeking better returns. In addition, where the benefits accrue to TNCs from the donor countries, bypassing developing-country firms, there is the risk that, increasingly, aid will be tied to the delivery of goods and services of donor countries’ companies.

In view of these drawbacks, the international community should consider further exploring the functioning of these mechanisms and their potential development impact before making policy recommendations in this regard. There should be an ex

ante evaluation to ensure that the additional investment funds will support companies that would not otherwise invest for the stated purposes and activities, and to ascertain that those companies do not have access to any other funds. The impacts

on poverty reduction and development should be clearly demonstrable. Moreover, the opportunity cost of using ODA to attract private finance may be too high. Instead, it might be preferable to direct the ODA flows towards building the productive private sector of developing countries by supporting their domestic SMEs and smallholder farmers. It is also important to prevent such aid from becoming a mechanism

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Despite recent increases, ODA still remains well below both commitments and requirements.

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The opportunity cost of using ODA to leverage private finance may be too high.

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for transferring risks from the private to the public sector, with the latter paying in case of failure of a project but with potential profits mainly reverting

to the private sector. Finally, the funds leveraged in this manner should be based on the same principles of effectiveness as relate to ODA in general.

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## C. Public-private partnerships for development

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A PPP is a contract between a government and a private company under which the private company finances, builds and operates some element of a service which was traditionally considered a government domain.<sup>13</sup> In some forms of PPP, the private company even “owns” the underlying assets needed to provide the service for a period of time. The company is paid over a number of years, either through charges paid directly by users, or by payments from the public authority, or a combination of both. Since the private partner is not necessarily a foreign investor, and does not necessarily obtain financing from external sources, PPPs themselves do not only represent a vehicle for international financing. Indeed, as illustrated below, several large countries frequently have sizeable domestic firms that are able to implement large-scale investment in infrastructure and operate the PPPs.

PPPs have been used widely in developed and developing countries over the past 20 years, and are currently seeing a revival of interest in the context of negotiations on finance for development and the Sustainable Development Goals. There are hopes that “harnessing” the private sector in this way can help multiply millions of dollars into billions, and billions into trillions.

PPPs may appear to be effective in terms of generating and implementing infrastructure projects when public budgets are constrained, and there are certainly some success stories in this regard. If properly managed, they can also improve the efficiency of the public service through the technical expertise provided by the private sector (ECLAC, 2015). However, there is also evidence of many pitfalls

and unexpected fiscal and other costs, and rarely, if ever, is their performance properly compared to other available mechanisms such as traditional public procurement and delivery systems. The evidence across decades and countries suggests that public sector finance will still have to do the heavy lifting. A cautious approach is needed if PPPs are to deliver the expected development benefits and to avoid, or minimize, the potential costs such partnerships can generate (IEG, 2014).

### 1. Scale, scope and use of PPPs

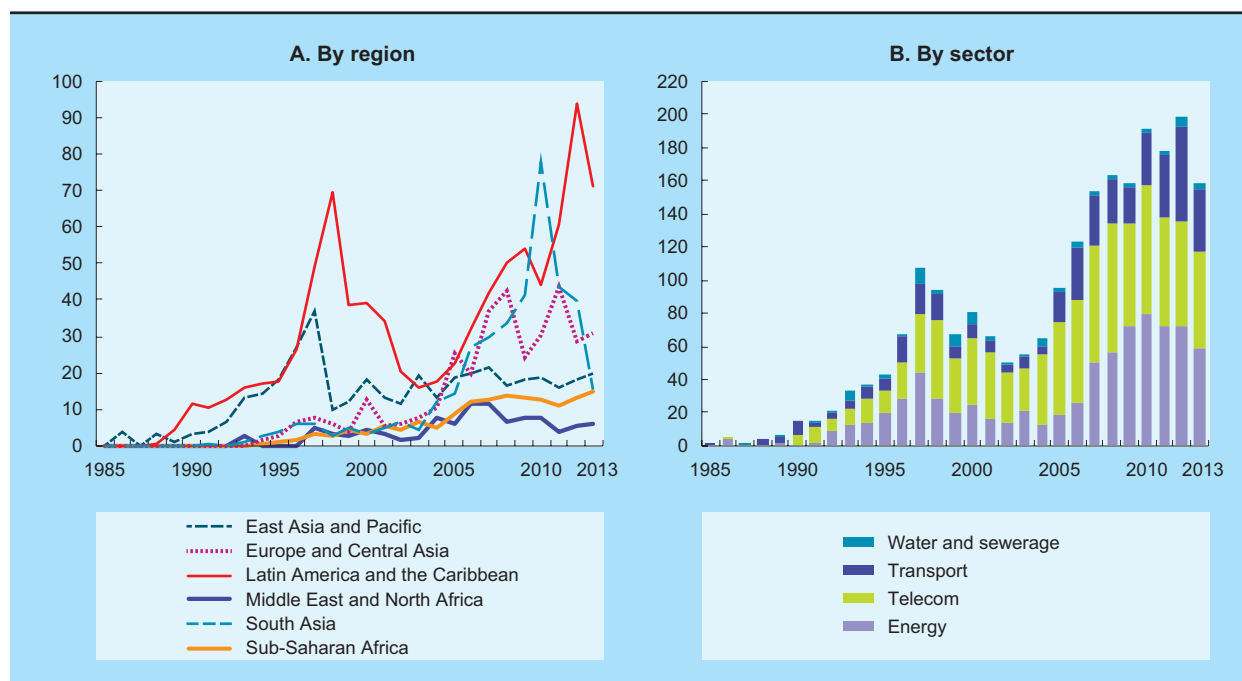
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In 2013, PPP funding for infrastructure projects in developing countries amounted to about \$159 billion, having recovered after the economic and financial crisis in 2008–2009 but falling sharply from a peak in 2012.<sup>14</sup> Even with the recent downturn, the use of PPPs has increased markedly since their introduction in the 1980s (chart 6.3A), recovering from setbacks following the Latin American and Asian crises, as well as Enron and other corporate scandals which affected even those countries that had previously been successful in attracting capital (World Bank, 2009). Their use in developed countries has also shown a broad overall increase, and again reflects sensitivity to external shocks and the broader economic cycle. However, in Europe, the value of PPPs was around 13 billion euros in 2012, the lowest in at least 10 years. These recent trends point to the challenges that lie ahead. Never has the cost of debt been lower and yet it is increasingly difficult to finance new infrastructure investment, especially

Chart 6.3

## PRIVATE SECTOR PARTICIPATION IN INFRASTRUCTURE, 1985–2013

(Billions of current dollars)



**Source:** UNCTAD secretariat calculations, based on World Bank, *Private Participation in Infrastructure Project Database* (as on July 2015).

**Note:** Country groups in chart A are those of the source. Investments refer to the year of implementation.

when equity commitment is a requirement (Helm, 2010).

PPP investment has been concentrated in relatively few countries and sectors. Almost 60 per cent of the total private participation in projects recorded in developing countries was in China, Brazil, the Russian Federation, India, Mexico and Turkey (by order of magnitude). This is an indication that PPP investors are not dissimilar from other institutional investors, preferring large and dynamic markets to the more vulnerable economies where financing needs are greatest. Of the developing regions, Latin America has traditionally hosted the largest share of PPPs and still accounted for 45 per cent of the total in 2013. Only 10 per cent of the total went to Africa, although in sub-Saharan Africa investments have been steadily rising (primarily because of investments in telecoms).

Also, PPP investments have been concentrated in relatively few sectors, with telecoms accounting

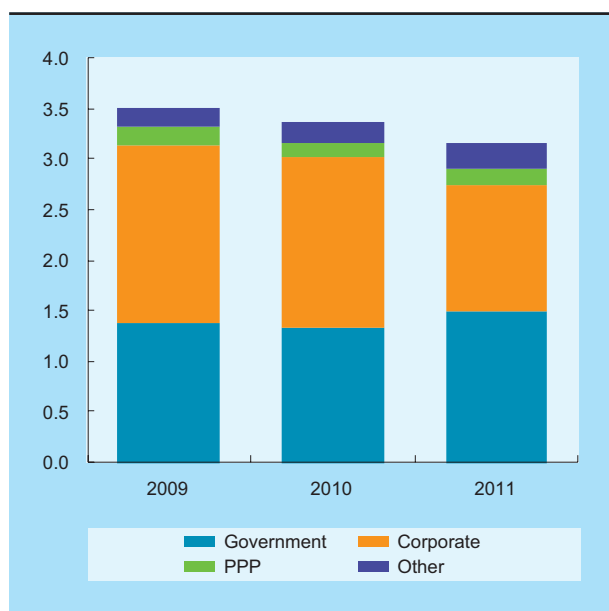
for 37 per cent of the total, or \$58 billion, in 2013, and energy for 37 per cent of the total, or \$59 billion (chart 6.3B). Water and sanitation are among the most needed infrastructure services to relieve human suffering, and yet they are the least likely to be financed through this method, having received a mere \$3.5 billion in 2013 (see also UNCTAD, 2013). Indeed, most commercial interest has been directed to ICTs and energy-related activities, while socially challenging sectors attracted almost no private activity (AICD, 2010). PPPs also appear more likely to emerge in brownfield projects (changing ownership of assets that already exist) than in completely new greenfield projects or risky transformative activities such as those related to climate change (WEF, 2014).

Unsurprisingly, therefore, the growth in the use of PPPs has not relieved State responsibilities for investment in infrastructure development, and the public sector's contribution continues to be essential, especially at times of uncertainty. Estimates of

Chart 6.4

### INFRASTRUCTURE SECTOR FINANCING IN THE EUROPEAN UNION, BY CATEGORY, 2009–2011

(Per cent of GDP)



Source: European Investment Bank, 2012.

the share of public investment in infrastructure vary from anywhere between 75 per cent and 90 per cent (Estache, 2010; Briceño-Garmendia et al., 2008; Hall, 2015). Even in the European Union, PPPs, on average, contribute a very small share to total infrastructure investment, with some countries deciding not to use PPPs at all (chart 6.4). In developing countries, governments financed around 70 per cent of infrastructure investment during the period 2000–2005, rising to 90 per cent for the lowest income countries.<sup>15</sup> To a large extent, this reflects the very nature of infrastructure. As the World Bank (2009:78) has noted, “many governments see the private sector as a solution. However, private financing, while offering additional resources, does not change the fundamentals of infrastructure provision: customers or taxpayers (domestic or foreign) must ultimately pay for the investments, and cost-covering tariffs (and well-targeted subsidies) remain the centre-piece of all sustainable infrastructure provision, public or private.”

As a result, even with PPPs, public finance remains critical. Of the total investment in developing

countries broadly described by the World Bank as PPPs, public debt and equity accounted for 67 per cent and private debt and equity accounted for the remaining (Mandri-Perrott, 2014). Moreover, these data relate only to the phase before projects are operational, after which contingent liabilities and other charges generally add considerably to the total public costs.

Historically, private participation in infrastructure has been dominated by large TNCs domiciled in OECD countries (OECD/NEPAD, 2005), especially for large-sized projects. Data from the World Bank PPI Database for the period 2010–2014 suggest that foreign actors are still a significant presence in many developing countries, accounting for around 58 per cent of PPP investments in Mexico and 35 per cent in China (calculated as the share of investments with either full or partial foreign sponsorship). One implication of this for developing countries is that it adds some of the risks associated with private external financing discussed in previous chapters, in addition to the other aspects of infrastructure provision. Projects may be financed through international lending, involving foreign currency exposure for both debt repayments and dividends, while the returns (profits, if there are any) are in the weaker, local currency. Sudden exchange rate shocks can dramatically affect profitability, as was experienced in Latin America and South-East Asia during the 1990s, which “helps to explain the diminished enthusiasm for such projects on the part of the international investment community” (OECD/NEPAD, 2005: 171).<sup>16</sup> Therefore, in some countries, the currency risks of PPP projects are borne by the host government. However, during the period 2010–2014, for four of the six developing and transition economies that account for the largest share of PPPs, the PPI database suggests that domestic firms are more significant than foreign ones. In India, 81 per cent of projects had domestic sponsorship only, in China the share was around 60 per cent, in Turkey it was 55 per cent and in Brazil 39 per cent (compared with 14 per cent attributed to foreign firms acting alone).<sup>17</sup> In particular, domestic sponsorship appears to be linked with smaller sized projects, but it is too early to tell whether this is a permanent change in financing sources or a cyclical one related to the post-crisis environment. In any case, if funds are borrowed internationally, foreign-exchange concerns remain the same regardless of the nationality of project partners.

Some of the larger companies involved in PPPs are quasi-public monopolies in their home countries; others share cultural or linguistic links with the host location.<sup>18</sup> This concentration means that governments negotiating the terms of private participation in PPPs do not necessarily deal with a number of competing atomistic suppliers. For example, there tend to be no more than two or three bidders in transport tenders (Estache and Serebrisky, 2004), and competition can be further limited by multi-stage bidding processes, whereby a company is selected in the first round without having to specify contract details until the second round from which competitors have been removed. Furthermore, a government may be dealing with a corporate entity with market power comparable to or even greater than its own (OECD/NEPAD, 2005). Not only can this create imbalance when the terms of contracts are agreed upon, it can also affect conflict resolution if things go wrong, as the partner companies may be large and powerful enough to “take on the regulators” in case of conflict (Shaoul, 2009).<sup>19</sup>

## 2. *Assessing the contributions and costs of PPPs*

One of the most common reasons for governments to choose PPPs over their own direct investment and procurement is that they are expected to bring additional finance, beyond what governments can provide. However the results are at best ambiguous. Some observers have argued that additionality is more likely to occur in developing countries than in developed ones (Winch et al., 2012), especially if capital is raised from outside the country. But after reviewing the World Bank’s decade-long experience of supporting PPPs in transition, developing and least developed countries, the Independent Evaluation Group (IEG) concluded that “contrary to intuition, PPPs generally do not provide additional resources to the public sector” (IEG, 2014: 6). If PPPs were more efficient than the public sector and could offset their higher financing costs, they could provide additionality in the sense of creating savings. However, the results in terms of improved efficiency have been mixed.

Moreover, the experience in developed countries is that the benefits of additionality can only be

realized under very specific conditions. In reality, some may be a form of “pseudo-additionality facilitated by accounting rules” (Winch et al., 2012: 15), whereby PPPs become a means of avoiding administrative (as opposed to macroeconomic or real) constraints, such as fiscal responsibility requirements. Implementing projects with off-budget finance from the private sector is one way to avoid such constraints. However, insofar as there are other fiscal costs emerging over time that have to be included in the budget, such as subsidies or other incentives that must be provided at a later date, even this accounting “advantage” may be – and typically is – short-lived.

Another argument in favour of PPPs relates to their greater efficiency and ability to deliver better value for money. According to measures of business performance during the construction phase, most of the PPPs supported by the World Bank were successful in the sense of being completed on time or within budget, with 62 per cent of those reviewed by the IEG rated satisfactory or better. However, broader measures that indicate longer term sustainability over the lifetime of a project are not estimated. Out of 128 projects studied, only 10 recorded results of service quality, 8 recorded results in terms of efficiency, and 1 reported fiscal results. Improved access to services for the poor could be confirmed in only about 10 per cent of cases (IEG, 2014). Owing to the scarcity of data, it is difficult to draw conclusions about the impact of PPPs on end-users.

It has been noted that PPPs are generally more costly than traditional procurement or provision of services through the public sector if only because governments can borrow more cheaply than the private sector.<sup>20</sup> An OECD survey of the 18 countries with sufficient information to report on the percentage of PPPs’ contribution to public infrastructure found that, “there is little information to assess empirically whether PPPs outperform TIP [traditional infrastructure procurement] projects over the lifetime of the project. This contrasts strongly with the purported motivation of going the PPP route, namely the maximization of whole-of-life value for money” (Burger and Hawkesworth, 2013: 69).

There are also relatively little data on the development impact of PPPs. Their performance over time tends to be greatly affected by the fact that more than half of all PPP contracts have been renegotiated, on average every two years (IEG, 2014). New terms



have typically favoured the concessionaire, with tariffs rising, fees falling or obligations being postponed, thus again adding potentially to the burden on the government partner to ensure that an adequate service is provided (in quality, price and coverage). This is not limited only to World Bank-supported projects; the OECD survey of member countries using PPPs found that when contract renegotiations took place at the request of the private partner, there was a high probability that the government lost value for money compared with the originally negotiated contract (Burger and Hawkesworth, 2013).

All this has meant that the scale of obligations and liabilities that governments have incurred through the use of PPPs has been surprisingly high, and thus merits greater attention. Liabilities may be explicit or implicit, contractual or non-contractual. Some are evident from the outset. For example, in China, foreign investors usually request a guaranteed fixed or minimum return; in the Republic of Korea, the offer of a guaranteed minimum revenue played a significant role in attracting private capital, but also caused moral hazard problems (Winch et al., 2012). Other liabilities may emerge over time, which is potentially a big problem for governments, given that projects have a life span of 30 years or more.

For the 128 PPPs in its sample, the World Bank concluded that it was not possible to show how much risk was being borne by the private or public partners because “downstream contingent liabilities are rarely quantified at the project level” (IEG, 2014: 40). This is partly due to a lack of standardized financial reporting, which makes it difficult for both investors and governments to judge the risks involved in PPP projects. China has sharply reduced the use of PPPs because they were found to be creating liabilities that were difficult to manage at local levels; following a peak of up to 6 per cent of government expenditure and 0.8 per cent of gross domestic product (GDP) during the period 1995–1997, they have fallen swiftly (Ahmad et al., 2014). Brazil introduced exposure limits for state and local governments and some states have already reached the limit, prompting calls for federal assistance.

This could be an issue not only for countries that are new to PPPs, but also for those countries with

PPPs already in place. An OECD survey found that most countries rely on medium-term affordability when making a decision about whether to use PPPs or traditional infrastructure procurement. However, the longer term view can be very different, and governments need to budget the full capital costs up front (Burger and Hawkesworth, 2013). Even if the cost of a project is expected to be fully covered by user charges, rather than through government revenues, planners need to be aware of the fiscal implications

in the future if, for some reason, payment by users does not work out, for example if demand is lower than anticipated, or if consumers are unwilling or unable to pay. Once future government commitments are reported over the lifetime of a project, this can significantly increase the actual fiscal cost. In the United

Kingdom, for example, concerns about the scale of the unitary payments the Government is required to pay each year (around £9 billion per annum for the next few decades) prompted the United Kingdom Treasury to review all PPPs and issue new guidelines.

Government liabilities can arise in various ways, whether from formal commitments through contracts or informally, stemming from the simple fact that governments are the providers of last resort. When things go wrong, the fiscal costs can be high, as exemplified by infrastructure-related experiences in Mexico. In the early 1990s, Mexico initiated an ambitious road-building programme involving more than 50 PPPs (concessions) to build and manage 5,500 km of toll roads. The concessions were highly leveraged, with loans provided at floating rates by local banks, which were owned by sub-national governments and were under pressure to support the project through lending. User tolls were expected to provide the revenues that would not only repay the debt, but also provide the private partners’ profits. However, costs proved to be higher and traffic volumes lower than anticipated, interest rates rose over time, and the banking system absorbed the increased liabilities. The system had already been struggling when a macroeconomic shock made matters worse. The Federal Government stepped in, even though there were no explicit guarantees compelling it to do so. It restructured the entire road programme, bailing out concessionaires, taking over 25 of them, and assuming close to \$8 billion in debt (Ehrhardt and Irwin, 2004).

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The scale of obligations and liabilities that governments have incurred through the use of PPPs has often been much larger than anticipated.

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In several countries, unsatisfactory outcomes of PPP projects meant that some schemes were given up early. Specifically with regard to water, more than 180 cities and communities in 35 countries have taken back control of their water services in the last 15 years (Water Justice, 2014). Such “re-municipalizations” have occurred for three main reasons: widespread problems affecting water privatization, seemingly independent of the country or regulatory regime; the equal or greater efficiency of public water services and lower prices that can be achieved when dividends or profits do not need to be paid to private operators; and the comparative advantage of the public sector in providing for human welfare and realizing social and environmental objectives (Lobina and Hall, 2013).

### 3. Policy implications

PPPs may remain a useful source of long-term financing for development, given the paucity of other external resources, particularly if real and perceived fiscal constraints persist, which prevent governments from directly undertaking public procurement for long-term development needs. However, it is important for governments to fully understand the various consequences and ramifications of such mechanisms, and be mindful of the potential costs and benefits over the entire life of a project so as not to experience unpleasant fiscal shocks subsequently.

To begin with, this requires efforts to improve transparency and accountability in PPPs, including standardizing the process for covering and reporting on public transactions, and, in particular, adopting accrual accounting systems that consider long-term investments and liabilities. Even when there are no explicit guarantees by governments, it is likely they will have to assume a significant share of liabilities. A particular concern is that many countries still do not have the basic accounting systems needed. Ironically, those countries that may have the highest hopes for PPPs may be the ones with the least capacity to manage them properly.

It is also necessary to improve the decision-making processes with respect to PPPs. As a mechanism for ensuring long-term investments with social goals, PPPs may not be appropriate in all circumstances. Therefore, a proper assessment needs to be conducted before they are selected in preference to other means of providing public goods and services. This also involves better pre-project planning, careful comparison with other means such as procurement, improved transparency with respect to contractual terms – including renegotiations and options for exit or breaking of contracts – as well as identifying and quantifying the fiscal implications. It further requires that governments disclose documents and information relating to PPPs and their contracts to encourage honest and transparent processes that are also socially accountable. It may also be useful to create a forum for the sharing of experiences and expertise, and build networks of developing countries for this purpose.

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## D. Can sovereign wealth funds make a difference?

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Many national governments or regional authorities that have been accumulating large amounts of foreign assets in recent years have established sovereign wealth funds (SWFs) as a more profitable way to use such assets instead of further increasing their international reserves. The total value of these public assets currently stands at more than \$7 trillion. This has raised hopes in some quarters that

SWFs could complement the existing sources of development finance, particularly since more than 40 of the 52 SWFs established since 2000 are based in developing countries and 32 of them hold more than \$10 billion in assets. Their total assets were estimated to be nearly \$6 trillion in March 2015 (SWF Institute, 2015), 87 per cent of which were funds from SWFs in only seven developing countries

(China, Kuwait, Qatar, the Republic of Korea, Saudi Arabia, Singapore and the United Arab Emirates).

Apart from the funds held for macroeconomic stabilization purposes only (which therefore hold swiftly deployable, highly liquid instruments such as government bonds or cash), many SWFs are mandated to build up capital reserves for future generations, and can therefore consider deploying their remaining funds for equity and “alternative investments” that are illiquid and long term. Some are even explicitly expected to support national or regional development through investments in infrastructure. SWFs typically have more freedom in their choice of asset classes compared with more risk-averse funds operated by central banks, pension funds and other funds. Hints of portfolio choices can be gleaned from examples of recent decisions by various SWFs: the Norwegian Government’s SWF recently made a climate-change-related pledge to exit global equities in coal, Singapore’s Temasek has investments in national and regional infrastructure, and the Fund for Productive Industrial Revolution in the Plurinational State of Bolivia has investments in medical, cement and food industries, among others.

In practice, few SWFs take advantage of this freedom to invest in ways that would support developing countries’ long-term investment needs. Rather, their investment decisions mirror those of private

market players, favouring some countries (e.g. China, the United Kingdom and the United States) and what they deem to be low-risk and short-term market sectors (Inderst and Steward, 2014; IPE and Stirling, 2013). And while more than half of all SWFs invest some resources in infrastructure (typically in energy, transport and telecommunications), these investments are again mostly in developed countries (Inderst and Steward, 2014).

SWFs’ decision-making processes are not well known, as fewer than half disclose details of their activities (Bauer, 2015). Some funds are constrained by their legal structures. For example, several funds, such as the Botswana Pula fund, are not allowed to invest domestically, but others have mandates that allow investing both domestically and in infrastructure. Technical assistance may help boost project management capabilities in developing countries, thus responding to criticism that some SWFs are unwilling to invest in those countries because there are too few large-scale projects to attract them. Some mechanisms for risk mitigation may help, such as pre-project appraisals or contingent guarantees. However, since the declared aim of SWFs is typically to save for their country so that future generations may benefit from today’s (possibly windfall) successes, this necessarily requires an emphasis on low-risk investments that yield positive returns, whether in social or financial terms.

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## E. Development banks: Their evolution and potential for supporting development

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### 1. *Distinctive features of development banks*

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Multilateral development banks have played and can continue to play a crucial role as providers of long-term financing that is not delivered by private lenders.<sup>21</sup> Typically, transformative development requires, among other things, large-scale projects of long maturity, which involve risks that private banks

are unwilling to assume, especially when their own liabilities are short term in nature. In addition, many large-scale projects generate positive externalities, and therefore social returns that are bigger than private returns. Development banks (both national and multilateral) are specifically designed to compensate for these shortcomings of private capital flows and markets. They have a clear mandate to support development-oriented projects that typically require long-term finance and a funding base whose liabilities

are predominantly long term and thus aligned with their mandate. Their capital is, for the most part, owned by highly rated sovereigns, which permits the banks to borrow long term in financial markets at relatively low costs.<sup>22</sup> In addition to their provision of long-term finance, development banks act as “market makers” by creating and providing financing instruments that better spread risks, both between creditors and borrowers and over time, including through co-financing with private investors.

Development banks can also help to overcome some of the informational deficiencies facing the private sector by assisting in the screening, evaluation and monitoring of projects. Unlike private banks, development banks tend to have in-house technical and managerial expertise which allows them to participate in decisions involving choice of technology, scale and location. This reinforces their ability to leverage resources, as they can attract other lenders that do not have the same technical capabilities to assess a project’s viability and potential. Development banks, therefore, have unique features that give them a strong comparative advantage over private financial institutions, including the tools to mitigate specific risks that the private sector is unwilling to take on, and the ability to exploit the complementarities between them and their private partners effectively (Buiters and Fries, 2002).

These banks are generally mandated to provide credit on terms that render industrial and infrastructural investment viable. They provide working capital and finance for long-term investments, sometimes in the form of equity. To safeguard their investments, they often closely monitor the activities of the firms to which they lend, sometimes nominating directors to the boards of those firms.

National development banks have long predated multinational banks. In Germany, for example, in the nineteenth and twentieth centuries German *Grossbanken* or universal banks became heavily involved in maturity transformation. Since such activities sometimes resulted in these banks experiencing illiquidity situations, they required constant and reliable access to last-resort lending by the Reichsbank, or central bank. It has been argued that

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Development banks have a clear mandate to support development-oriented projects that typically require long-term finance and a funding base whose liabilities are predominantly long term.

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this represented “a clear case of planned institution building”, to finance the necessary long-term investments. The universal banks were private, limited liability, joint stock banks, but they were also instruments of the State, acting on its behalf in return for large-scale liquidity support (De Cecco 2005: 355). Following the German experience, together with the experience of the main-bank system in Japan that financed export-led industrial expansion with support from and direction by the Bank of Japan and the Japanese Government, many developing countries have chosen to establish stand-alone

development finance institutions expressly geared to specific financing objectives (Chandrasekhar, 2014).

More than half of the development finance institutions in the developing world are relatively small, with assets of less than \$10 billion. However, about 5 per cent are mega-banks with assets greater than \$100 billion, including institutions like the China Development Bank (CDB) and the National Bank for Economic and Social Development (BNDES) of Brazil (Chandrasekhar, 2014).

Clearly, international or multilateral development banks can play even more significant roles if they also assist in reducing developing countries’ foreign-exchange gaps, and if they provide loans at even lower interest rates because of their greater ability to access global capital markets. As noted above, these financing gaps arise because of the public nature of some investment projects, the limited financing capacity of national (and sub-national) governments to undertake large projects, and the private sector’s unwillingness to undertake long-term, large-scale projects which they perceive as too risky. Since public investment, by nature, typically does not generate direct financial returns on investment, but only indirect and long-term returns in terms of higher growth, from which debt service can eventually be paid, this can be, and typically is, a major obstacle to commercial financing.

One area in which financing gaps remain huge is infrastructure, with an estimated current gap greater than \$1 trillion (Bhattacharya and Romani, 2013). As was evident in section C, even innovative

mechanisms to meet this gap through PPPs have thus far been inadequate, and furthermore, they have tended to involve very substantial fiscal costs. It has been estimated that in order to meet the growth and development needs of developing countries, infrastructure spending would have to increase from 3 per cent to 6–8 per cent of developing-country GDP. However, private sector infrastructure investment is not only relatively small, but also very concentrated in the energy, transport and ICT sectors (Estache, 2010). The lack of private sector involvement is particularly marked for regional infrastructure projects due to the complexity of the regulatory framework for cross-border projects and the political risks involved. Multilateral development banks, especially regional ones, can play a leading role in providing finance for regional infrastructure development, since they can tackle collective action and coordination problems due to their international or regional nature, accumulated knowledge and access to different financing and implementation instruments.

International development banks can provide low-income countries with loans for development projects at subsidized interest rates. In 2013, their concessional lending amounted to almost \$20 billion, which represented 30.4 per cent of their total loan portfolios.<sup>23</sup> In addition, both national and multilateral development banks can play countercyclical roles, providing project finance to fill in gaps when private lenders reduce credit during recessions and crises (Ocampo et al., 2007). They may also be able to sustain or even increase lending during economic shocks, such as sharp changes in commodity prices or natural disasters. This in turn can help a country sustain its level of income and economic activity, as well as its capacity to import after such a shock. This was evident during the global financial crisis, for example, when lending by both the CDB and BNDES was sufficiently large to offset some of the likely declines in investment during the crisis (Ferraz, 2012). Some regional banks such as the European Investment Bank (EIB) have the explicit mandate to provide countercyclical lending,<sup>24</sup> which demonstrates that international/regional development banks, along with their national counterparts, can directly help support income and employment as part of their policy goals.

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In recent years, some national development banks have become increasingly significant international players, providing external financing as part of their international operations.

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## 2. The changing landscape of development banks

Over more than half a century, the World Bank and various regional development banks such as the Asian Development Bank (ADB), the African Development Bank (AfDB), the Inter-American Development Bank (IADB), EIB and the Islamic Development Bank (IDB), have played a vital role in financing long-term projects around the world. They have helped to fill some financing gaps, especially in large-scale infrastructure projects, and, more recently, in social and environmental projects. Despite their presence, however, given the relatively modest size of their loans, they have been able to only slightly reduce these gaps.<sup>25</sup>

Other subregional development banks have also partially covered these financing needs. In the Latin American and the Caribbean region, these include the Central American Bank for Economic Integration, the Caribbean Development Bank and the Andean Development Corporation (Corporación Andina de Fomento, or CAF). The latter, now known as the Development Bank of Latin America, was created with a mandate to promote sustainable development and regional integration among its

founding member countries, the Plurinational State of Bolivia, Colombia, Ecuador, Peru and the Bolivarian Republic of Venezuela. Membership has been gradually expanded since the bank's creation to include most Latin American and Caribbean countries, as well as Portugal and Spain. The bank supports the strengthening of its members' national productive sectors,

particularly the development of value-added products and services, as well as job creation and the promotion of access to social services, including education, health, water and sanitation. In 2013, loan approvals by the CAF surpassed \$12 billion, which was a similar amount to the total loans of the IADB.<sup>26</sup> Although the CAF is owned mostly by developing countries, the bank has a fairly large capital base, which, together with the excellent record of repayment on its loans, has contributed to its investment grade status from the international rating agencies – a rating that is higher than that of most Latin American countries. The



bank's clear and focused mandate, lean management structure, rigorous economic evaluation of projects, rapid approval process and loans granted without conditionality help to explain its success and consistently high credit rating (Griffith-Jones et al., 2008).

In Africa, the AfDB is an important source of external long-term finance. Africa also has a large number of subregional banks, including: the East African Development Bank, the West African Development Bank, the Central African States Development Bank, the Eastern and Southern African Trade and Development Bank, commonly known as the Preferential Trade Area Bank (or PTA Bank) and the Development Bank of Southern Africa (wholly owned by South Africa but serving the Southern African Development Community, with a focus on large infrastructure projects). However, these banks have limited capacity to provide finance for large development-oriented projects on a scale that meets the needs of their respective subregions.<sup>27</sup> This may be explained by their small capital base, and by the fact that most of their shareholders are the borrowing countries themselves, which have limited financial resources to expand these banks' capital bases substantially. In Asia, the ADB plays a major role in financing long-term projects, including in infrastructure, as there is a lack of subregional banks.

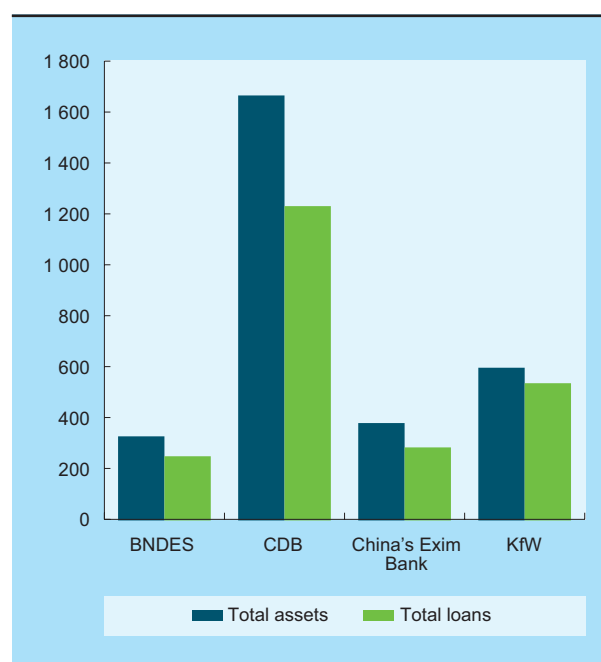
In recent years, some national development banks have become increasingly significant international players, providing external financing as part of their international operations. The most active international lenders have been China Development Bank (CDB), the Export and Import Bank of China (China Exim Bank), Brazil's BNDES and the German Development Bank, *Kreditanstalt Für Wiederaufbau* (KfW). The international operations of these major development banks account for a significant proportion of their total assets and loans, which can be quite large (chart 6.5).

The CDB and China Exim Bank are two of the three "policy" banks that China created in 1994 to support specific development goals set by the Chinese Government. The CDB is a primary provider of long-term finance for infrastructure projects, such as railways, roads and telecommunications, and for large-scale investments in basic and heavy industries, such as petrochemicals. China Exim Bank's mandate is to support China's exports and imports of mechanical and electronic products, equipment and high-tech

Chart 6.5

### TOTAL ASSETS AND LOANS, SELECTED NATIONAL DEVELOPMENT BANKS, 2014

(Billions of dollars)



Source: Banks' annual reports.

products, as well as overseas investments of Chinese companies. The bank also acts as the financing arm of China's international cooperation programmes by providing concessional lending abroad (Poon, 2014; China Exim Bank, 2014).

Since the early 2000s, both of these Chinese banks have been active providers of international finance to developing countries. Their loans have supported China's "going out" strategy as part of its new role as an emerging superpower on the global stage. Recent initiatives include their planned contributions to the new "Silk Road" strategy that involves large infrastructure investments across Asia, along with continuing financing in Africa, Asia and Latin America through South-South cooperation agreements.

In 2014, the CDB's foreign currency loans totalled \$267 billion, accounting for about 22 per cent of its entire loan portfolio. They generally support infrastructure development in different developing countries, while facilitating China's access to raw

materials at lower transportation costs.<sup>28</sup> The bank also provides financing through other mechanisms, such as the China-Africa Development Fund (CAD Fund), to which the bank was the sole provider of capital funds in its phases I and II. In 2014, the CAD Fund committed \$3.1 billion of investments in 80 projects in a range of areas, including regional aviation, ports, electricity, pharmaceuticals and vehicle assembly (CDB, 2014).

Together with the CDB, China Exim Bank has strongly supported China's strategic partnership with other developing countries. It has made preferential loan commitments to different countries and regions, including Africa, Asia and the Pacific, Central and Eastern Europe and the Caribbean (China Exim Bank, 2014). In 2014, its actual export seller's credit disbursements reached \$287.8 billion, of which 15.2 per cent was spent on overseas construction contracts and 7.9 per cent on overseas investment projects. Recently, the bank has provided support to "the development of high-speed railway, expressway and regional aviation networks (the 'Three Networks') in Africa" through loans (part of these concessional) and other assistance mechanisms (China Exim Bank, 2014: 9).

In addition to these Chinese national development banks that have an international reach, another prominent national development bank is Brazil's BNDES, which has been providing financing for development, both nationally and abroad, in recent years. Created in 1952 with an initial focus on financing domestic infrastructure development as part of the country's strategy of modernization and industrialization, it subsequently broadened its focus to foster Brazil's capital goods industry and other industrial sectors. Since the 1990s, it has also been providing financing to exporting sectors. In the 2000s, the bank expanded its international operations, reflecting the willingness of Brazil's Government to play a greater role on the international stage. This new strategy has included supporting regional economic integration and therefore investment promotion in neighbouring countries, as well as strengthening Brazil's economic links with fast-growing developing regions, particularly Africa. The bank's loans have also bolstered the internationalization of large Brazilian corporations.

In 2014, 14 per cent of the bank's total loan portfolio was in foreign currency. Since BNDES figures among the largest national development banks in the world, with a total loan portfolio of \$245 billion

in 2014 (chart 6.5), its provision of foreign loans is significant, especially for smaller countries that lack funding for large-scale development projects. In South America, for instance, the bank has played a very important development-supporting role by lending to small countries such as Ecuador as well as larger ones such as Argentina, to finance economic infrastructure. In Africa, it has extended loans to large national construction companies investing in infrastructure and other projects.

An example of a national development bank from a developed country is KfW. It has been playing an increasingly important role internationally as the lending arm of Germany's development cooperation programmes. It promotes development programmes in all developing regions. At the end of 2014, its loan portfolio totalled \$536 billion (chart 6.5), and 10 per cent of its business promotion activities were related to development programmes around the world. Its mandate is to improve living conditions in Germany, Europe and around the world sustainably, such as by promoting climate-friendly economic development, including in developing countries. Its projects include power supply lines in India, a solar thermal power plant in Chile and sustainable housing construction in Africa (KfW, 2014). Parts of these financing programmes are linked to the bank's participation in a variety of climate protection initiatives, such as the Initiative for Climate and Environmental Protection and the International Climate Initiative. It has also created a Climate Insurance Fund aimed at supporting local insurance and reinsurance companies, and it is expected to contribute to the new United Nations Green Climate Fund (GCF) for climate protection and adaptation. In addition, the German Government channels funds through this bank for the provision of grants and highly concessional loans to LDCs (KfW, 2014).

### **3. The potential financing role of South-led multilateral banks**

A system of development banks that provides international financing to support growth and development should include South-led multilateral banks, alongside multilateral, regional and subregional banks and national banks with international operations. Recent initiatives to design and set up such



banks are aimed at addressing the shortage of long-term capital for investment in crucial infrastructural areas and capital-intensive industries essential for development. These initiatives include the newly created New Development Bank (NDB) set up by the group of countries known as the BRICS (Brazil, the Russian Federation, India, China and South Africa), the Asian Infrastructure Investment Bank (AIIB) and the Bank of the South. The decisions to create these institutions are partly motivated by the disillusionment of developing countries with the governance structures, patterns of lending and the conditionalities associated with lending by the Bretton Woods institutions and by some of the leading regional development banks.

The NDB was established at the BRICS Fortaleza Summit of July 2014, with the specific mandate for “mobilizing resources for infrastructure and sustainable development projects in BRICS and other emerging and developing economies” (BRICS, 2014, paragraph 11). This focus is clearly justified in the light of the large unmet needs in these areas, as highlighted above. It has been established with an initial authorized capital of \$100 billion (and a subscribed capital of \$50 billion). According to the declaration of the VII BRICS Summit in July 2015 in Ufa (Russian Federation), the NDB is expected to start approving its first investment projects at the beginning of 2016 (BRICS, 2015a). The quality of its loans to infrastructure and other projects should be an important priority so as to maximize the development impacts of such projects and minimize risks of default. Moreover, the ability to make profits will help the bank expand its capital base, and therefore increase its lending in the future.

In terms of geographical coverage, it would be important for the NDB to have a balanced portfolio of loans that include both middle- and low-income countries, since this mix would generate benefits of geographical diversification and make the bank more creditworthy. In order to lend to low-income countries, there is a case to be made for including a subsidy element, making loans to this group of countries concessional. The creation of a trust fund, funded by developed countries, could support such loans (Griffith-Jones, 2014).

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A system of development banks that provides international financing to support growth and development should include South-led multilateral banks.

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The Asian Infrastructure Investment Bank was established in October 2014 in Beijing, with 33 founding members from within the Asian region and 17 (including several developed countries) from outside the region; an additional seven prospective members have yet to sign on.<sup>29</sup> Most of the bank’s authorized capital stock of \$100 billion will be contributed by China. In order to reflect the regional character of the AIIB, its regional members will be the majority shareholders, holding approximately 75 per cent of shares. The bank’s creation is a response to the recognition of the importance of infrastructure to the development of Asia, and the need for significant additional long-term financing for building infrastructure in the region. While the ADB estimates Asia’s infrastructure financing needs to be around \$720 billion per annum over the period 2010–2020, its own annual loan approval amounts to only \$13 billion (Junio, 2014). The AIIB aims to finance both national and regional infrastructure projects. The latter should aim to support trade and further development of the region’s production networks. The main funding mechanism will be through the issuing of bonds, both in regional and global markets.

In Latin America, the Bank of the South (Banco del Sur) is a subregional entity whose founding member countries are all from South America: Argentina, the Plurinational State of Bolivia, Brazil, Ecuador, Paraguay, Uruguay and the Bolivarian Republic of Venezuela. Established in 2009 with a promised initial capital of \$20 billion, it aims to promote economic development and regional integration in the South American subregion.

None of these three banks is in operation yet, but they are promising signs of a renewed interest both in development banks and in the need to finance infrastructure creation for social and economic development. They also add to an environment of healthy competition with other development banks; for example, partly as a response to these developments, the World Bank has decided to step up its presence in the area of infrastructure development by setting up a Global Infrastructure Facility (GIF), which it defines as “a global open platform that will facilitate the preparation and structuring of complex infrastructure PPPs to mobilise private

sector and institutional investor capital.”<sup>30</sup> This is an ambitious step, given the World Bank’s relatively limited spending on infrastructure development so far – about \$24 billion in 2014, up from \$16.7 billion in 2013<sup>31</sup> – and its mixed record on social and environmental standards. Nevertheless, it points to the possible catalytic role these new institutions may play in changing both the conditions and the approach of existing multilateral financing institutions. Further, they could become a driving force for collaboration in a network of development banks, creating synergies and complementarities among them.

In this network, the new South-led banks could work closely with national development banks, particularly from the BRICS countries, such as Brazil’s BNDES, the Development Bank of Southern Africa and China’s CDB, as was proposed at the VII BRICS Summit in July 2015 (see BRICS, 2015b). While multilateral banks may have greater expertise in the engineering and financing aspects of loans, national development banks have greater local knowledge, thereby helping reduce asymmetries of information at the national level.

These new South-led banks are expected not only to supplement the amount of financing for

long-term investments that are on offer globally, but also to better serve the interests of economic development, along with greater concern for sustainability and inclusiveness, than multilateral banks that are dominated by developed countries. This would depend on several factors. One is the degree to which the emergence of these banks is able to significantly alter the global financial architecture, and perhaps, therefore, the behaviour of the institutions that currently dominate it. Another relates to whether they would differ in their lending practices from the established institutions – not just increasing the quantity of financing for long-term development, but also changing its quality to focus more on inclusive and sustainable economic transformation. Thus, while greater diversity in the international financial and monetary landscape is certainly welcome, and the additional resources that these new institutions provide can have a significant positive impact in terms of generating more long-term financing for development, it does not necessarily follow that there will be major changes in the terms and conditions of such financing. For this to happen, governments and civil society in developing countries will need to place greater emphasis on monitoring the funding patterns, terms and conditions in the lending activities of the new development banks.

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## F. Conclusions

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In a world economy inundated with liquidity, the main obstacle to financing development is not the lack of financing capacity. Rather, the question is how to move resources from highly leveraged institutions with short-term financial horizons to economic agents wishing to finance long-term investment projects that generate large positive externalities and therefore encourage additional investment. This report stresses that this cannot be ensured simply through the workings of market mechanisms, either nationally or internationally. This is because private financial institutions are naturally driven by a profit motive, whereby during a boom, they tend to produce too much credit and debt, while during a bust, credit ceases and a debt deflation sets in.

As a consequence, and left to itself, private finance finds it difficult to incorporate social or development benefits in its calculations. Where there are externalities, as with public goods, private finance is insufficient for social needs. In addition, private finance has tended to be geographically concentrated in high and middle-income countries and in sectors in which profitability is more assured, rather than in risky projects or projects with long gestation periods that may be more necessary for industrialization and development. Within countries, private finance tends to provide less financing to SMEs, to sectors that are characterized by different forms of risk such as agriculture, to projects with bulky upfront investment requirements such as economic infrastructure and to

necessary social investments in health, sanitation and education, among others. Yet sufficient spending in all of these areas is clearly essential for a sustained and inclusive development process.

Therefore, ensuring financing for development requires specialized agents and mechanisms designed specifically for this purpose, in which the role played by the public sector is crucial. This chapter has reviewed the most important potential sources of international finance that, having some degree of public involvement, may be used for development finance. Related mechanisms may result directly from public spending, as with ODA and other forms of cooperation, may involve changing the terms of profitability and the incentives available to private investors to consider externalities, as with PPPs, or may emerge from public institutions, such as development banks set up for this purpose, which are effectively underwritten by the government.

ODA remains the only existing mechanism whose central aim is to redistribute income at the global level. Despite its potential, the amount of ODA has remained far short of both needs and expectation. In the past few years, there has been progress regarding both the amount of assistance provided and efforts to improve its effectiveness. In addition, South-South cooperation has been significantly increasing. However, most ODA still reflects flows from developed countries to developing countries, and closing the gap between the current level of such ODA (0.29 per cent of GNI of developed countries) and the committed level of 0.7 per cent remains of the utmost importance for sustaining development strategies, particularly in LDCs. In this context, there is an increasing focus in the debate on financing for development on the potential use of ODA to catalyse additional resource mobilization, both public and private. However, the use of public aid for leveraging private finance should be considered with caution, to avoid the risk of privatizing benefits and socializing losses. The opportunity cost of using ODA for this purpose may be too high.

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This chapter has also shown that, despite their recent popularity, experience with PPPs has been mixed and rather limited in terms of generating additional private investment in desired areas.

As with other blended finance instruments, PPPs may “lower investment specific risks and incentivize additional private sector finance across key development sectors” (Addis Ababa Action Agenda of the Third International Conference on Financing for Development in 2015). However, the scale of obligations and liabilities that governments have incurred through the use of PPPs has often been much larger than anticipated and, therefore, the fiscal costs have often been so high as to suggest that governments could have more effectively and efficiently engaged in public investment in these areas directly. Therefore, there is a need to improve pre-project planning processes, increase transparency and accountability and identify fiscal implications for the duration of such projects.

Finally, multilateral and regional development banks that are dedicated to the special challenges inherent in infrastructure could play a greater role, delivering technical assistance as well as finance. Indeed, existing and new development banks have a primary role as providers of long-term financing, vis-à-vis private financial institutions. Since they have a clear mandate to support developmentally oriented projects and a funding base whose liabilities are predominantly long term, as well as in-house technical expertise that allows them to participate in decisions involving choices related to technology, scale and location, they have unique features that give them a strong comparative advantage over private financial institutions. International development banks can, in addition, play an important countercyclical role through their provision of crisis financing to individual countries, in response to an economic shock (e.g. commodity-price related) or a natural disaster, which can help sustain levels of income and economic activity and the capacity to import during downswings. ■

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## Notes

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- 1 A target of official flows equivalent to 0.75 per cent of each developed country's GNP was initially adopted at the second conference of UNCTAD in New Delhi in 1968. This proposal was accepted by most, but not all, developed countries. After further negotiations, this initiative was approved by the United Nations General Assembly of October 1970, although the target was lowered to 0.7 per cent of GNP. This commitment was endorsed by the members of OECD-DAC, which defined ODA as "those external financial flows which are provided by official agencies, have the promotion of economic development and welfare of developing countries as its main objective, and are concessional in character."
- 2 Only five members exceeded the target of 0.7 per cent of GNI: Denmark, Luxembourg, Norway, Sweden and the United Kingdom (OECD, 2015).
- 3 Developmental ODA includes social infrastructure and services, economic infrastructure and services and production sectors, which in 2013 represented about 63 per cent of total registered ODA.
- 4 For empirical evidence on the relationship between aid and growth, see *TDR 2008* and UNCTAD, 2006. For more recent reviews on the literature relating to this, see Alonso, 2012; Edwards, 2014; Glennie and Sumner, 2014; Morrissey, 2015; Qian, 2014; and Quibria, 2014.
- 5 Such costs increase by 15–30 per cent, on average, and by as much as 40 per cent or more for food aid (DIIS, 2009).
- 6 On aid predictability, see OECD at: <http://www.oecd.org/dac/aid-architecture/> (accessed 21 July 2015).
- 7 The remaining 61 per cent was "phantom aid" – aid which was not targeted for poverty reduction, or was double-counted as debt relief, overpriced and ineffective technical assistance, tied to the purchase of goods and services from the donor country, poorly coordinated and with high transaction costs, too unpredictable to be useful to the recipient, spent on immigration-related costs in the donor country or spent on excessive administration costs.
- 8 Evidence of this can be found in the high-level forums on aid effectiveness held in Rome (2003), Paris (2005), Accra (2008) and Busan (2011).
- 9 Even with the recorded increases in formal, untied aid, some part of it may still be "de facto" tied. This may be due to donor regulations, lack of local capacity, difficulties for local and regional contractors to compete internationally, unequal access to information, potential risk aversion on the part of donors and pressure for speedy implementation (UNCTAD, 2011b).
- 10 Similarly, the Addis Ababa Action Agenda of the Third International Conference on Financing for Development (13–16 July 2015) stresses in its paragraph 54: "An important use of international public finance, including ODA, is to catalyse additional resource mobilization from other sources, public and private. It can support improved tax collection and help strengthen domestic enabling environments and build essential public services. It can also be used to unlock additional finance through blended or pooled financing and risk mitigation, notably for infrastructure and other investments that support private sector development."
- 11 However, "evaluating blended projects is not easy and it can be difficult to demonstrate key success factors, such as additionality, transparency and accountability and to provide evidence of development impact" (UNCTAD, *World Investment Report 2014*: 169).
- 12 See for instance, Griffiths et al. (2014), UK Aid Network (2015), Concord (2014), ActionAid (2014), Bretton Woods Project (2012), Eurodad (2012), ActionAid, Eurodad and Oxfam (2015), Eurodad (2013), Kwakkenboms and Romero (2013).
- 13 Definitions of PPPs vary considerably, reflecting different institutional arrangements and conceptual understandings, but they nonetheless share many similarities. In their simplest form, PPPs "refer to arrangements where the private sector supplies infrastructure assets and services that traditionally have been provided by the government" (IMF, 2006:1). Such a definition can encompass existing assets and the acquisition of new ones, and user-pays services, or free-to-user systems where governments pay a unitary charge to the provider. Other definitions focus on risk and how it is intended to be allocated between the public and private partners. For example, one



- definition states that PPPs are “an agreement between the government and one or more private partners (which may include the operators and financiers) according to which the private partners deliver the service in such a manner that the service delivery objectives of the government are aligned with the profit objectives of the private partners and where the effectiveness of the alignment depends on a sufficient transfer of risk to the private partners” (OECD, 2008: 17). In practice, much of the current debate concerns the perceived imbalance of risk between public and private partners; in particular that the public sector carries too much risk, especially in the long-term operational phases of a project as opposed to the first couple of years during which construction takes place.
- 14 Most of the data used in this section are drawn from the Private Participation in Infrastructure (PPI) Database, produced jointly by the Infrastructure Policy Unit of the World Bank’s Sustainable Development Network and the Public-Private Infrastructure Advisory Facility (PPIAF), which is a multi-donor trust fund. The database records contractual arrangements related to infrastructure projects in low- and middle-income countries (as classified by the World Bank), in which private partners assume some degree of operating risk through ownership, finance or operational activities. It focuses on sectors with a degree of monopolistic or oligopolistic characteristics, including energy, telecommunications, transport and water. Such “private participation” should not be equated with private investment in infrastructure. First, it does not necessarily correspond to real investment, as it also includes management and lease contracts, concession projects and divestitures; second, recorded investment refers to what was committed (not necessarily made) for the whole project; and third, when project companies are owned by both public and private parties, the database presents the investment by both parties, not by private investors alone.
  - 15 See World Bank (2009). Notable exceptions were middle-income countries, and the ICT and telecoms sector, where private sector finance was more forthcoming.
  - 16 For example, the French company, Suez, pulled out of a water concession in Argentina after the peso fell steeply in 2002 and the authorities did not agree to increase charges to offset the devaluation. Largely as a result of the devaluation, there were 28 proceedings against Argentina under the International Convention for Settlement of Investment Disputes (ICSID) by early 2004 (OECD/NEPAD, 2005).
  - 17 The other two countries are Mexico and the Russian Federation.
  - 18 Of the top five developing countries hosting PPPs, Spain and the United States together account for almost 30 per cent of projects with uniquely foreign sponsorship, potentially reflecting language or proximity factors.
  - 19 On the challenges that this may pose to competition policies, see <http://unctad.org/en/Pages/DITC/CompetitionLaw/ResearchPartnership/Contact4114.aspx>.
  - 20 A review by the United Kingdom’s National Audit Office (2015) found that private finance deals were charged an interest rate that was double that of all government borrowing. This trend has been consistent over time: in 2010 *Infrastructure UK* estimates that the cost of capital for public funding was 3.9 per cent, compared with costs of up to 6.9 per cent for firms operating in regulated markets (e.g. privatized water or electricity utilities) and 10.9 per cent for firms in unregulated markets (e.g. concessions for user-pay services).
  - 21 This has been reaffirmed in the Addis Ababa Action Agenda, which states in its paragraph 75: “Development banks can play a particularly important role in alleviating constraints on financing development, including quality infrastructure investment.”
  - 22 Regional development banks with excellent records of credit recovery can have even better ratings than the States that own them.
  - 23 This refers to the total multilateral lending by the World Bank, the African Development Bank (AfDB), the Asian Development Bank (ADB), the Inter-American Development Bank (IADB) and the European Bank for Reconstruction and Development (EBRD).
  - 24 Since the global crisis, the EIB has played a strong countercyclical role to help sustain income and investment levels across Europe and protect the region’s infrastructure and productive capacity from the effects of the deep economic downturn. The Bank’s provision of finance is enlarged by its leveraging and by combining resources from other sources of financing (e.g. the European Union budget and the private sector), which implies a large multiplier effect (<http://www.eib.org/about/index.htm>, accessed 9 March 2015).
  - 25 In 2014, gross disbursements by EIB (\$78 billion) and the World Bank (\$44 billion) were by far the most significant, compared to IDB and ADB (about \$10 billion) and AfDB (almost \$5 billion), as noted in the banks’ annual reports.
  - 26 See CAF Factsheet 2014 at: [www.caf.com](http://www.caf.com).
  - 27 The total assets of the Development Bank of Southern Africa amounted to \$6 billion as of end-March 2014. Those of the West African Development Bank, PTA Bank, Central African States Development Bank and East African Development Bank were \$3 billion, \$2.5 billion, \$0.5 billion and \$0.2 billion, respectively, as of December 2013, as noted in the banks’ annual reports.

- 28 For example, some foreign projects the CDB currently supports include the Las Bambas Copper Mine in Peru, to which it has committed \$3.5 billion (and disbursed \$2.6 billion by the end of 2014), a coal-fired power plant in Bali, Indonesia, to which it has committed \$473 million (and disbursed \$367 million), and the upgrading of the Mansa-Luwingu Road in Zambia, to which it has committed \$175 million (and disbursed \$65 million) (CDB, 2014).
- 29 See <http://www.aiibank.org/>.
- 30 See <http://www.worldbank.org/en/programs/global-infrastructure-facility>.
- 31 See <http://www.worldbank.org/en/news/press-release/2014/07/18/world-bank-group-infrastructure-spending-increases-to-24-billion>.

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