



# **SOLIDARITY AND THE SOUTH**

## NEW DIRECTIONS IN LONG-TERM DEVELOPMENT FINANCE





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Edited by  
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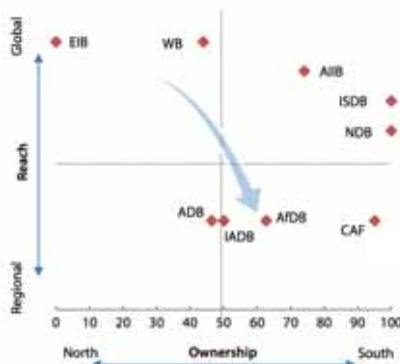
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# Introduction – the New, Southern-led landscape of development finance

*Diana Barrowclough and Ricardo Gottschalk*

The world of long-term development finance created a new centre of gravity in recent years, based in the south and oriented to the south (see chart 1 below). This new, Southern-led landscape of development finance is potentially one of the most significant trends in decades. In part, it is a response to the economic crisis of 2007-2008, which provoked many developing countries to seek resilience and a bulwark against economic vulnerability in an uncertain and unbalanced world. It is also a response to long-held frustrations with the limitations of the existing international financial architecture, that failed to provide sustainable long-term finance to many parts of the world and to essential activities, in particular infrastructure. However regional integration, and in particular regional financial integration, has an equally positive propulsion that reflects a shift in development paradigm towards a more Solidarity-imbued approach – supported by the economic opportunities that can lie in enlarged regional markets and internal sources of demand as opposed to those that are distant and may offer less potential growth; similarly to creating regional pools of finance that can understand and support regional investment needs. No less importantly, it is also helping developing countries create a ‘voice’ that is more commensurate with the realities of their economic weight.

**Chart 1** Turning South - the new centre of gravity of development finance



*Source:* Authors’ estimation, based on banks’ annual reports. Ownership calculated according to member country voting rights; reach calculated according to geographical locations and loans.

This compendium presents some of the key elements of this trend, focusing on south-south banks, funds and other forms of regional financial integration. It shows a recognition of the power that comes when countries collaborate and stand together, melding national development objectives with those of their region. National development banks are increasingly taking a wider view, towards neighbouring countries and their regions; infrastructure targets are regional as much as local; and local and regional markets are being treated as important, or potentially more important, than global ones. This is not to say that international multilateral support is not important – in fact it remains essential – but the broadening and deepening of an interlinking network of strong national and regional institutions dedicated to financing long-term sustainable development is a very welcome advance.

Alongside this trend towards regionalism, there has also been a significant change in attitude towards development banks, recognising they fill an essential purpose that commercial banks cannot fulfil. After decades of somewhat neglect, they are in the centre stage and moreover, their ambitions have become wider and greater. Indeed, chart 2 shows that, among southern development banks, their international footprint has become quite significant in recent years, nearly matching the size of loan disbursements by long-established multilateral development banks.

**Chart 2**      **Loan disbursements by development banks, 2016**



*Source:* Authors' estimation based on banks' annual reports. Long-established Banks include ADB, AfDB, EIB, IADB and WB. Southern banks include AIIB, BNDES, CAF, CDB, Ch Ex Bank, IsDB and NDB. These are banks' gross disbursements. In 2016, except for IsDB, AIIB and NDB, which are based on loan/finance approvals. For BNDES, CDB and Exim Bank China, these are authors' own estimates of foreign disbursements.

If the Millennium Development Goals galvanised attention towards rather narrow, poverty oriented development goals, the Sustainable Development Goals created a much broader vision of what should be aimed for. There is still much to do to support the new banks and institutions in their efforts to achieve the SDGs, including by ensuring governments have sufficient fiscal space to give the banks the capital support they need; to insist that narrowly defined financial yardsticks do not overwhelm broader developmental indicators of impact; and by ensuring national or regional development strategies are designed in a way that sees infrastructure and industrialisation in the whole rather than as discrete ‘projects’ to be financed. Nonetheless, hopes are high that this could be a turning point.

Indeed, both in Africa and Latin America there has been a concerted effort to give a big push towards regional integration by means of various institutional initiatives aiming for not just trade but above all infrastructure-led productive integration. These initiatives have included creation of free trade areas and infrastructure development programmes; and, very importantly, have been underpinned by development banks, seen as key tools to finance projects that can generate long-term synergies and spill-overs that are not easily captured by strict financial viability assessments. Even in Asia, a region where much trade integration has taken place over the years on the back of regional value chains, China’s led Belt and Road and other initiatives seek to provide much infrastructure needed for a further deepening and expansion of regional integration, so that those countries left behind can be brought to the fold and catch up with the rest of the region.

The selection of papers and discussions in this volume is unusual in that it brings together first-hand experiences of lenders, borrowers and practitioners from Development Banks and funds (including the founder members of a new Southern-based bank), alongside the views of academics and policymakers. The aim is not simply to document trends but rather to share experiences and expertise, in order that countries can be better prepared for the exciting new opportunities that south-south financial integration is creating, and the challenges that still need to be addressed.

The papers are brief and highlight key and topical aspects of these new trends rather than going into deep or theoretical analysis<sup>1</sup>. In their breadth, they show the reconfiguration of global economic and political strength that is taking place and its implications for development. The new landscape that is being formed by this combination of fissures,

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<sup>1</sup> For this, more detail can be found in the Routledge publication forthcoming “Southern led development finance – solutions from the global South”, edited by D. Barrowclough, K. Gallagher and R. Kozul-Wright.

fault-lines and folds is providing significant benefits for development but it is far from complete and important gaps and limitations remain.

Most of the writings presented here stem from a four-year, multi-regional, UNCTAD research and consensus-building project that was designed in response to a request from member states for more and better information (See Acknowledgements section for more background); in addition to research carried out for UNCTAD's Trade and Development Reports over recent years, including 2015, 2016 and 2018. Taken together, the selection shares some important findings about the way new institutions are emerging and long-standing ones adapting, as they expand and alter their mission in order to contribute more effectively to the needs of development in the post-crisis world.

Setting the global scene and opening the compendium, Professor *Ilene Grabel* shows how the world has been reconfigured in a profound and important way following the global crisis of 2007-2008. It is significant for south-south integration that the crisis originated not in developing countries (as with previous Asian, Latin American and Russian crises) but rather, was borne in the markets, institutions and architecture of the world's most advanced economies and financial centres. Developing countries responded to the crisis by seeing it as an opportunity for transformational change. Without overstating the case (because the situation is still ad-hoc and far from complete), they responded with a flurry of experiments with bilateral, regional and even multilateral new institutions. These did not for the most part reject the IMF and in cases strengthened it; but nonetheless the pragmatism and rising confidence in the Global South lead to new reserve fund arrangements, new currency mechanisms and even new sources for long-term development finance that are not dependent on the multilateral institutions. In a few years, she argues, this moment might appear as a fundamental turn in the developing world – towards financial resiliency and increased policy space that permits a genuine, sustainable and inclusive human development.

The paper by *Diana Barrowclough* reminds us why the new institutions were needed in the first place, and how these reasons have only accentuated in the decade since the economic crisis and in light of the new ambitions articulated in the SDGs. Today's excessively financialised global economy is not only crisis prone, bringing volatility, instability and abrupt capital reversals -- it also fails to generate the kinds of finance needed for development. It is hyper-liquid without bringing funds destined for long-term investment either. Adding to the problem is the fact that economic transformation costs more than it used to in terms of capital investment and it is harder because the industrialization and support policies that proved essential to today's developed economies have been taken off the table. So the stakes are high and the new

development banks emerging from the South can potentially make a big contribution – both in finance and in technical expertise.

But this does not mean the State can stand back. These banks still need strong public support in terms of capital and technical capacity – that is, with long-term planning and management skills as well as a secure long-term capital base. To overcome negative biases of Credit Rating Agencies, or to benefit from employment generating opportunities, also requires south-south cooperation and solidarity. Moreover, governments need sufficient fiscal space to earn the revenues that will eventually support the various modalities of long-term investment – which in turn means increasing efforts to reduce illicit financial flows, to stop the ‘tax caves’ that divert billions of government funds, and to keep tax levels at a level sufficiently high enough to finance government policies. If one country tries to do this alone, the funds simply flow to the others and the ‘race to the bottom’ continues. Hence the new southern-based development finance institutions need to be supported in a wider context of the developmental state, and of south-south cooperation.

Subsequent papers focus on regional and institutional aspects of these challenges. In Latin America, as in many developing countries, the current global economy has caused difficulties even in regions which had already integrated more closely and adapted financial institutions following previous crises. Speaking from the perspective of South America, *Pedro Silva Barros* notes that the entire region currently faces a global environment that is much more challenging than that of the previous decade – which had nonetheless succeeded in creating regional integration institutions such as UNASUR and other structures. Compared to that expansionary period the region since then faced a period of low dynamism, with rising unemployment, limited intra-regional trade and a lack of investment in infrastructure. Now, in a period of greatest need, Barros said that he hoped countries would be more able to “walk together” than they had in the past, because now they really needed to. Previously, during the expansionary phase, even though there had been a shared ideology about the importance of the integration process, progress had been made in some important areas but not in others. Now as conditions became more demanding, progress could potentially be made on other fronts.

Asia had also created a variety of ‘regional self-help’ initiatives in the early 2000’s which will nonetheless likely face testing times ahead, according to *Dr Mah Hui Lim*. His paper sketches the political economy of the birth of Asian initiatives that followed the 1997 Asian financial crisis. With his insider view gained through working in a major international bank at the time, he saw personally the challenges involved in sovereign debt restructuring on a large scale. Malaysia accepted support from the IMF although



the injection of funds was not needed, and after six months' experience of the IMF Programme it decided this was the wrong course; Indonesia and Thailand accepted IMF support but remained unhappy with the restructuring and conditionalities imposed – the consequence being a search among the Asian countries for an alternative regional financial architecture.

Such an alternative architecture needs to have both defensive and developmental elements, and Lim argues that so far Asia has concentrated rather too much on the defensive aspect. This includes the Chiang Mai Initiative (CMIM), which redefined the relationship of the region with the international financial institutions such as the IMF. However, Lim warns that similar attention needs to be given to the role of long-term investment and development banks. He notes that for many Asian countries like Japan, the Republic of Korea and Singapore, their development was financed by long-term credit and long-term development banks, which were in turn supported by developmental states. “Unfortunately, they have forgotten that history and swung to capital markets, which is quite unfortunate”.

In a different but related message, *Theotonio dos Santos* from Latin America urges developing countries to use regional integration and its institutions in a strategic manner, to gain a stronger negotiating position in global trade and investment negotiations by having a clear regional position. A new world order is already emerging whereby China is now the world's largest economy, when measured by purchasing power parity; India is the third largest, and Brazil features in eight position. This new ranking is also reflected in trade patterns and in the composition of the world's largest corporates – many of which are from developing countries and often also state-owned.

Not all countries are using their new found strength in the most beneficial way, however. Whereas some are using their foreign reserves to invest in new development banks and funds, or to intervene in international financial markets, others have tended to buy the United States treasuries instead – missing a valuable opportunity to support investment in their regions. Dos Santos hoped that the financial structures discussed in this volume, such as the new Bank of the South and the BRICS New Development Bank, can be used to help countries enter global negotiations with a clear perspective and a long-term objective. How to keep a long-term financial focus is the subject of the remainder of this compendium.

In a rapidly changing development finance landscape, *Ricardo Gottschalk* observes that development banks at all levels, with their deep pool of knowledge on development and track record on design and management of complex projects, are well suited institutions for the new challenges of the 21<sup>st</sup> century, such as the need of large infrastructural

investments for transformational and sustainable growth. These banks can and indeed have played in recent years a growing role as sources of additional development finance. But what has been particularly new has been i) the greater engagement of national development banks in regional and international development, evidenced by the rapid growth of their international loan portfolios; ii) the more prominent role of sub-regional development banks, which have scaled up and diversified their operations in support of regional integration and development more broadly; and iii) the creation of new southern-led development banks, which have started their operations promising to be different: more flexible, more innovative, more democratic in their governance structures and more tuned to the needs and aspirations of developing countries. In addition, these new banks are showing a keenness for cooperating with other financial institutions, signalling a healthy build-up of a network of development banks. In Gottschalk's view, this looks encouraging, as it may be pointing to a future of a more integrated development finance system that is better equipped to address different development goals.

*Rogério Studart* then makes the point that national and regional development banks have indeed a critical transformative role to play, particularly during challenging times as is currently the case. All these banks are now focusing on the theme of infrastructure and on sustainable infrastructure in particular, which is important for the promotion of both inclusive growth and long-term environmental sustainability. This demonstrates willingness of confronting the following critical challenges of our times: i) poverty and inequality; ii) environmental crisis and climate change; iii) creation of dynamic source of aggregate demand to promote growth and employment. Latin America should use national development banks as tools to help countries from the region to promote regional integration and develop their productive capacities and their domestic markets, and to avoid the alternative formula of liberalization in factor markets aimed at gains in productivity and competitiveness. Unlike multilateral banks such as the World Bank, which is focused on improving the business climate, national and regional development banks can focus on infrastructure development, key for structural transformation, and on their ability to leverage private capital, necessary to meet the large financing infrastructure needs. These are banks that can help find local solutions for long-term challenges.

*Kevin Gallagher* documents the incredible expansion of Chinese development finance. In a very short time period, China became the leader in global development finance in material terms as, going against the trend of Western lenders in the traditional multilateral banks, China opted to increase its paid-in capitalization of its two global policy banks and also helped set up two new ones – the New Development Bank and the Asian Infrastructure Investment Bank. While the size of the funds made available are perhaps

the most striking aspect of China's profile in southern-oriented development finance, other themes are just as important. China has explicitly linked its funding with national development goals; it does not require policy conditionality to be attached to its loans; it lends according to a special 'consortia' structure that is different from operations; it has focused more on large infrastructure and industrial projects that are more conducive to long-run transformation and growth than the composition on offer from other MDBs. However, Gallagher warns, these projects are not without risks and China and host countries alike need to put in place necessary risk adjustment and mitigation techniques to safeguard for debt sustainability. It also needs to address social and environmental risk and social inclusion.

The *Louis Calle* piece turns to CAF, the Latin American Development Bank, but avoids covering the ground we all already know: the bank's expanding loan portfolio, rapid loan disbursements, no conditionality attached, and focus on regional integration and social sustainability. It, instead, focuses on the point that CAF has no donor countries, or did not have them until recently, and therefore its need to partner with international institutions that can provide CAF with cheaper resources, in addition to technical assistance and knowledge transfer. By having access to cheaper sources of funding, CAF can provide finance on cheaper and longer terms to its borrowers, compared to what otherwise would be possible, given that CAF funding model is based on its issuances in international financial markets. The bank thus has established various cooperation initiatives with international agencies involving concessional credit facilities, technical assistance, transfer of knowledge and creation of fund with green content. Partners include the European Union, the BRICS NDB, KfW and the Global Environmental Fund. All these kinds of cooperation help attract funds that take advantage of knowledge that CAF has of the region, and to make projects viable through provision of a concessional element. This approach is, in a sense, ad hoc, serving as a proxy for an own development fund, which CAF does not have, unlike the large multilateral financial institutions.

Another bank with a long history is also responding to the new conditions. Writing about the Inter- American Development Bank IADB, *Javier Díaz Cassou* observes that the bank is an old institution and therefore represents the *status quo*. Yet, he then makes the point that the build-up of a new regional financial architecture in Latin America can learn a great deal from the bank's accumulated experience and that, therefore, it would be a pity if this were not the case. Cassou also stresses the emphasis the bank places on regional integration projects, partly because the bank itself is a regional institution – thus emphasis on regional integration is a natural vocation for the bank; and partly due to the commonly accepted reason that many countries from the region are too small to develop productive capacities that need economies of scale, and therefore the need

for larger markets for growth and productivity gains. Cassou also makes the point that the move from single to multiple partners (or executors, as framed by Cassou) implies considerably greater complexity, making projects progress at a slower pace, which can be discouraging at times. Another aspect he highlights is the complementarity and, indeed, interdependency of various activities of the bank, which can be illustrated in the context of integration – for example, the supply of roads across borders, which requires regulatory harmonization to generate the expected outcomes.

Moving from national and regional to the new cross-south banks, *Marcelo de Lima* describes the role and areas the BRICS National Development Bank will become engaged in, through its expected operations and portfolio of loans. Lima makes the noteworthy observation that infrastructure and sustainable development, two key concepts touched upon by virtually all authors in this volume, are totally intertwined and cannot be treated separately. This is a point the NDB seems to be taking heartfully by putting strong emphasis on supporting sustainable infrastructure. According to the bank's *General Strategy: 2017-2021* document, NDB greatly emphasizes not only sustainable development but also the flexibility required to respond to unanticipated changes related, say, to disruptive technologies, which will imply new demands and ways of doing things. Although the bank is considering expansion of membership, it will do so only gradually while retaining control in the hands of the founding members to ensure it maintains its identity of a truly southern multilateral bank.

In countries in Africa, *Cyril Prinsloo, Chelsea Markowitz, El Mostafa Jamea and Kwame Owino* take a further look at NDB's policies to discuss in detail what the bank promises will be at the core of its operations: the use of country systems (UCS), e.g., public financial management and environmental and social frameworks, and briefly report UCS by selected African economies. Prinsloo et al. remark that the UCS approach is untested and thus it is still to be seen how it will play out. South Africa has strong country systems and uses it to leverage resources on more favourable terms from the MDBs and as a tool to achieve its development objectives. Although Kenya also has robust country systems, unlike South Africa, it allows for the use of donor systems along with its own, which implies a 'hybrid' approach in which MDB requirements are adapted to the Kenyan context. Morocco, in turn, seems to fall in between with a more ambivalent attitude towards UCS: in some instances, the country rejects external rules, while in others it accepts them by recognizing the limitations of its own processes.

Taking an African perspective, *Stephen Karingi* provides a rationale for why regional integration is a critical development goal: like Cassou, he sees it as a way of removing constraints relating to small economic size, which limit the ability to

industrialize; helps reduce costs associated with fragmented markets and can help attract foreign investment and technologies, which need economies of scale. Karingi shows that, following the Abuja treaty and the creation of the African Economic Community (AEC), African regional integration has gone through different phases with (apparently not met yet) targets that include stabilization of tariff and non-tariff barriers, harmonization of customs duties and, more recently, the establishment of a free trade area (FTA) in the African continent. Other goals, to be pursued in the coming years, include common sector policies, macroeconomic convergence and ultimately a Pan-African economic and monetary union, underscored by an African Central Bank and a single currency. The challenges, which are many, include how to maintain dynamism across the continent, how to dynamize intra-African trade, how to link trade liberalization with industrial development, and how to support infrastructure development. Karingi strongly emphasizes the need for financial sector development that includes a role for development banks, to support the integration process, both national and regional, and identifies infrastructure deficiencies as a major challenge to integration.

*Walid Abdelwahab* gives the perspective on Islamic banking, through the globally present Islamic Development Bank. Abdelwahab notes that, in the changing landscape of development finance, a paradigmatic shift is taking place, away from a narrow focus on poverty reduction and towards broader growth and sustainable development. In this new environment, multilateral development banks (MDBs) face new additional demands. They are expected to be more flexible and agile, have a fairer governance system with more representation from developing countries, and be not only providers of finance but also facilitators and catalysts of private capital. In dealing with growing and multiple demands, the MDBs have to find a fine balancing act between selectivity and diversity, and to focus more on the regional and local dimensions of development.

The final part of the compendium presents papers from founding governors and the first president of the new Bank of the South. Adopting a similar line of reasoning to that exposed by Studart, *Pedro Buonomo* asks about the need to change the region's productive matrix and to invest massively in infrastructure development to make regional integration possible. *Andrés Arauz* talks about the region's vulnerabilities and the fact that the lengthy time taken for the bank to become fully operational has played to its advantage, as it has helped its formulators to develop ideas and concepts on how to maximize its role and effectiveness once it is running; and of the institutional developments that have taken place, particularly COSIPLAN with its various projects, which the Bank will be able to support and engage with.

Finally, *Eudomar Tovar* provides a broader analysis, placing the role of the bank in light of an adverse international context in which the United States interest rates are rising and attracting additional resources, to the detriment of Latin America. He sees the bank as a tool to capture part of the capital Latin American banks and other institutions have invested abroad, to help reduce the foreign exchange shortages that countries of the region are currently facing. We criticize the current international financial architecture, which only provides always the same, and proposes the Bank of the South as an alternative tool, a bank that can do things differently. But he makes the point that integration is an old proposition in the region and what is really missing is the political will to not only conceptualize new institutions but to put them into operation.

To conclude, if we want to make the most of the opportunities in today's new development finance landscape, it would help to give equal billing to the demand side of the equation as well as supply. The availability of finance is not on its own sufficient – what is also needed are projects, articulated in a developmental plan, and supported by the appropriate legislation, industrial and competition policies and regulations. This challenge was met in the past by developmental governments at the national level in many countries, and now needs to be revived and expanded to the regional level.



# PART 1: SKETCHING THE NEW, SOUTHERN-LED LANDSCAPE OF DEVELOPMENT FINANCE





# 1. Financial Crises and the Emergence of New Financial Architectures: Towards a Post-Neoliberal World

*Ilene Grabel<sup>1</sup>*

For critics of the United States - and IMF- led international financial order, such as myself and many others, the last few years have been important. Why? Because the global financial crisis that began in 2008 is in many important ways distinct from its predecessors. First, this crisis originated not in the developing world, as has generally been the case over the past 30 years, but in the markets, institutions, and failed regulatory architecture of the world's financial center. This is not to say that the developing world has been insulated from its effects, of course. Indeed, the spillover effects of the crisis have caused substantial harm across many countries. A second difference from previous crises is far more important. The global crisis has generated what I consider to be **productive consequences** as concerns financial architectures in the Global South and East. The global crisis is extraordinary in the degree to which it is contributing to a reconfiguration of economic and political power, a fracturing of neoliberal ideology, and is encouraging experimentation in financial governance in the Global South and East.

As one can infer from just these few remarks, I am among those who see in the global crisis opportunities for transformative change. That said, however, it is important not to overstate the case. It is too early to be certain that lasting, radical changes in the global financial architecture are afoot, or that the ideas about and the architectural experiments now underway are secure. Nor am I arguing that all regions of the developing world either enjoy the opportunity or have the means to reshape the global financial architecture. Rather, I have a more modest goal. I will argue that there are numerous opportunities for bilateral, regional, multilateral and trans-regional institutional experimentation in regards to financial governance, and there are clear signs that these opportunities are being exploited in a variety of distinct and encouraging ways. As compared to any other moment over the last several decades, we see clear signs of productive ruptures in thinking and in the institutions of financial governance.

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<sup>1</sup> These remarks draw on two papers by Ilene Grabel: "Post-crisis Experiments in Development Finance Architectures: A Hirschmanian Perspective on 'Productive Incoherence,'" *Review of Social Economy*, special issue on "Ethics, Finance, and the Great Recession," 73(4), 388-414, and "Financial Architectures and Development: Resilience, Policy Space, and Human Development in the Global South," background paper prepared for the United Nations Development Program, Human Development Report 012, March and published as Human Development Report Office (UNDP), Occasional Paper, June 2013.

### *The productive effects of the East Asian crisis*

Let me make a few comments on the East Asian financial crisis of 1997-98 since it plays such an important role in shaping the current environment. On the one hand, the Asian crisis deepened the move to neo-liberal reform in many countries through a variety of mechanisms, such as IMF conditions. At the time, there appeared to be little new in the nature of the crisis or in the crisis response.

*But in fact, the Asian crisis marked the beginning of the end of neoliberalism*

The severe constraints on policy space that followed the Asian crisis induced many developing countries to introduce strategies and institutions to escape the influence of the IMF. They did this by relying on an array of strategies, not least among them self-insuring against future crises by stockpiling official reserves.

The Asian crisis had other notable effects that bear directly on south-south regional financial and monetary integration. It turned attention in the region to the creation of a new institution, the Asian Monetary Fund, to serve as a counterweight or an alternative to the IMF. But despite the failure of the Asian Monetary Fund, the IMF paid price for mishandling the Asian crisis. Indeed, the IMF suffered a loss of purpose, standing and relevance. After the loans associated with the Asian crisis were repaid, the IMF's loan portfolio contracted dramatically as countries that could afford to deliberately turned away from the institution. This radically curtailed the geography of the IMF's influence.

### *The global crisis and global financial governance*

In contrast to the Asian crisis, the global crisis has been good to the IMF. It rescued it from the irrelevance that followed the Asian crisis by re-establishing its central place as first responder to financial crisis, though this time in peripheral European countries. The IMF's rescue was also facilitated by the massive funding commitments made to it by the G-20.

But the restoration of the IMF was associated with important changes. Developing countries were twice called upon to and did commit funds to the IMF during the global crisis. This was a landmark event at the institution. What is most important about these new commitments is that they reflected the growing economic power of some developing countries. Indeed, at the same time that some developing countries contributed funds to the IMF, they also became more outspoken in demands for long overdue governance reform. These demands finally bore fruit in 2015 - although very modestly - when the United States Congress stopped blocking changes in voting shares.

*The global crisis and transformations in financial architecture*

Unlike its predecessors, the global crisis induced a new pragmatism and rising confidence among policymakers in the Global South and East. This pragmatism and confidence - along with long-standing frustrations with the Bretton Woods institutions of the IMF and World Bank - has generated the most extensive proliferation of institutional innovations and experiments in the financial landscape of the Global South and East since the solidification of neoliberalism in the 1980s. The willingness and ability of policymakers to undertake ad hoc, uncoordinated innovations in financial architectures is one of the most important legacies of the global crisis, especially when compared to prior crises. These innovations are best understood as uneven, partial, experimental, contested, and incomplete. But they nevertheless represent the best chance for redirecting development in more promising, inclusive, and sustainable ways than at any time over the past many decades.

What I would like to do now is talk about architectural change, focusing on “reserve-pooling arrangements” and on institutions that provide development or infrastructure finance. I find a few things across these two terrains. For institutions that pre-date the global crisis, we find expansion in the scale of activity and geographic reach and introduction of novel mechanisms. We also find what I term “hybridization,” in which the distinction between liquidity support and development finance has become blurry as when a regional development bank provides counter-cyclical support. We also find that institutions have been created during the crisis, some focusing on reserve pooling, others on development finance, and some both. In the interests of time, and also since we have been privileged to hear directly from key actors at many institutions, I will paint the landscape of change in broad strokes by touching on a few illustrative institutions.

**Reserve Pooling Arrangements:** The reserve pooling arrangements that pre-dated the global crisis (namely, the CMIM, FLAR, and the Arab Monetary Fund) evolved in important ways during the crisis. For example, the CMIM deepened and expanded twice during the global crisis. It doubled the resources pledged by members, established an independent secretariat cum surveillance unit called AMRO, created a new precautionary support instrument, lengthened the maturity of the swaps available to members, and raised the threshold for member support not linked to being under an IMF program. The latter matter remains politically complicated, and neither of CMIM’s two support facilities has yet been utilized. FLAR provides both liquidity and precautionary support to members (among other services), and since 2011 has had its own macroeconomic monitoring unit, the Division of Economic Studies. During the global crisis it received and acted on requests for assistance to support balance of payments or liquidity from

only two members. The institution evolved importantly during the global crisis when we consider that its subscribed capital, and hence its capacity was expanded; it added two new members, and invited two others to formally begin the process of joining; and it played a more important role in improving the investment conditions of members' reserves. As with FLAR, the 22 MENA nations of the Arab Monetary Fund make capital contributions to the institution; it also conducts its own monitoring of borrowers. The Arab Monetary Fund has had a facility since 2009 that supports countries facing short-term liquidity problems caused by the global crisis.

During the global crisis, two new reserve pooling arrangements were created. The Eurasian Fund for Stabilization and Development is a hybridized body involving 6 Eurasian nations. It has liquidity support and development finance facilities. Surveillance functions are outsourced to the Eurasian Development Bank. The newest and trans-regional reserve pooling arrangement is the Contingent Reserve Arrangement - CRA, which provides liquidity support to BRICS during balance of payments crises. It has not been utilized in the few months since becoming operational. Its architecture is modeled on CMLM's, including linking support beyond 30% of access to an IMF program.

Looking across reserve pooling arrangements, key issues include how to manage the voice of diverse members, whether surveillance is in house or outsourced; whether and how to connect to other regional and multilateral bodies; and how to expand resources and geographic reach while maintaining a sense of ownership.

**Development Finance Institutions:** The terrain of development or infrastructure finance institutions is vast. My sample is necessarily small relative to the playing field. I examine a subset of national, sub-regional, and trans-regional institutions.

One development bank that I would like to mention is the Development Bank of Latin America (referred to as CAF – see chapter in this volume). CAF's capacity, reach, and role expanded during the global crisis. Its members twice agreed to increase subscribed capital; it added new members in the Caribbean; its project loans during both the 1990s and the global crisis played important developmental and counter-cyclical roles; and its loans remained high during the global crisis. In 2015, CAF increased its counter-cyclical role with what it called fast disbursing and contingent operations. It also continued to support the development of local currency bond markets.

Two national development banks bear mention. These are Brazil's National Bank of Economic and Social Development and China's Development Bank (described in subsequent chapters of this volume). Both provided vast disbursements of traditional

development finance during the global crisis, and both played hugely important counter-cyclical roles. Both increased the degree to which their international lending supported national economic interests, though the CDB's internationalization was far more expansive than that of BNDES.

The new players in the development finance landscape include the New Development Bank of the BRICS and a set of China-led development finance institutions and initiatives. The NDB, as we know, is designed to finance investment in sustainable infrastructure and development projects in the BRICS economies, and also externally in ways that support their economies. The ultimate goal is to allow other low- and middle-income countries to buy in and apply for funding. The NDB has made one loan financed by “green” (RMB-denominated) bonds issued in the Chinese market to each of its founding members in support of small-scale renewable energy projects. As of the time of writing, it was considering a second bond offering in the Indian market. Important issues confronting the NDB include how to incorporate new members (and give them the voice necessary to make membership attractive), how to ensure that loans are attractively priced in view of its likely less than AAA rating, and how to ensure that sustainability criteria and safeguards are in place.

China is positioned to be the largest source of development finance in the world. The AIIB represents the largest of China's contributions to the changing landscape. The AIIB has approved two batches of loans, many of which were energy related and co-financed with older multilateral development banks. The Board of Directors approved an “Environment and Social Policy,” though these standards remain an important issue. The other key challenge relates to China's voice vis-à-vis members. Another China-led initiative is the Belt and Road, which we might liken to a Marshall Plan. The Belt and Road is supported by the Silk Road Fund, the largest of 13 new regional or bilateral China-led funds. Official figures suggest that \$900 billion in deals are underway.

## Conclusions

There is so much more to be said about all of these matters, but I will conclude with just a few observations. Crises generally present opportunities as well as challenges. Sometimes, they generate deep ideational and fundamental institutional change. That is our situation today. The Asian and the global crises have created the conditions for expanded development-oriented policy space, a growing heterogeneity of financial architectures in the developing world, the opportunity to challenge outdated ideas about neoliberalism, and the widening of fissures in the traditional governance in the global

financial system. A long period of neoliberal conformity has finally given way to a period of aperture and experimentation in policies and institutions - a period of inconsistent responses, perhaps, but one that is potentially productive.

It is of critical importance that this moment not be wasted. The current environment poses many risks, as we all know. But unlike in the past, any new economic difficulties across the developing world are being met with a wide range of regional, trans-regional, multilateral, and bilateral institutional innovations in financial architecture that mark a further break with the crisis responses of the neoliberal era. Just as the Asian crisis laid the groundwork for institutional and policy developments that have deepened only in the global crisis, the current crisis has catalyzed innovation along the lines already in place, and in directions not previously imagined. In a few years when we look back at the present moment, we might come to recognize the present conjuncture as one marking a fundamental turn in the developing world--a turn toward financial resiliency and increased policy space that permits genuine, sustainable and inclusive human development.

## 2. Supporting the new landscape – development banks, public private partnerships, sovereign wealth funds and the un-sung role of the developmental state

*Diana Barrowclough<sup>1</sup>*

Southern led and southern-oriented banks and funds have gone from being a hope to a significant reality in an incredibly short time. This brief note sketches out the main changes in the landscape, reminds us why they emerged in the first place, and highlights the support they still require in order to play their hoped-for transformative role.

Most mappings of the new landscape focus on the rapid emergence and scaling-up of a few very large institutions, such as the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB, formally BRICs) Bank. Lending hundreds of millions of dollars to developing country projects within months of their inception, these multilateral, southern-owned and southern-oriented institutions are bold new steps that dramatically increased the footprint of south-south developing banking. However equally important are national development banks – some of which are very large indeed - two from China alone already lend more than the World Bank - but most are small and nonetheless usefully help to fill gaps in finance in places where resources are otherwise lacking. It is true that many of these are new (according to a recent World Bank survey, as many as 25% of national development banks worldwide were set up since 2000) but also older banks have been significantly expanded in financial terms and often reformed also in terms of governance and mandate in order to better fit the new expectations.

In addition to all this, there is a new awareness of the trillions of dollars in Southern-owned Sovereign Wealth Funds that are not currently, but could be, directed towards developmental investments. And the equally substantial south-south bond issuances and credit swaps that open the door to new sources of short or reasonably long-term finance<sup>2</sup>. New and old-expanded sources of short-term foreign exchange liquidity, such

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<sup>1</sup> This chapter is derived from presentations given by the author including “Regional financial and monetary integration – new institutions and their essential partner, what role for the State”, Quito, Ecuador 30 November 2016; “Scaling Development Finance for the SDGs and the Paris Agreement”, University of Boston 23 April 2018. And ‘Financing development: experiences of regional monetary and financial South South cooperation - the role of multilateralism in the current global economy’, SAIIA Johannesburg May 2017.

<sup>2</sup> See Barrowclough and Gottschalk (2018) for a review of this.

as the Latin American reserve fund (FLAR) or the Chiang Mai Initiative Multilateralisation (CMIM) provide a further source of emergency and counter-cyclical finance that may be short-to-medium term in maturity but which also has long-term implications. Hence it is no exaggeration to say that there is now a profound changed landscape of new and expanded financial institutions from the South.

Such mappings do not however focus on what is expected from these institutions or how they are supposed to operationalize these – which is a concern because expectations are very high. At UNCTAD inter-governmental meetings and other fora, developing country member states tell us of their hopes for the mechanisms and processes of financial and monetary integration discussed in this volume. We hear the same kind of messages from different countries and different regions. Country representatives say they want “disruptive innovation” to fix or replace a disfunctioning international financial system. They want to go beyond the current and traditional criteria for loans to have loans without policy conditionality and with only the condition of being repaid. They want to liberate their trillions of dollars of foreign exchange reserves, which are currently “sacrificed” as an insurance against external shocks, rather than being invested usefully in their own countries and regions. (In some countries, these reserves are as much as one quarter of GDP, so if they were used rather for investment this could make a big impact). They say they want to transform the multilateral institutions and to transform their economies; and, linked to both of these, to have a meaningful and commensurate voice in the world’s multilateral processes. Securing access to crisis-management counter-cyclical finance is one priority, but no less so is the complementary priority of securing long-term finance for development – which has now been visualized and augmented by the ambitions of the Sustainable Development Goals.

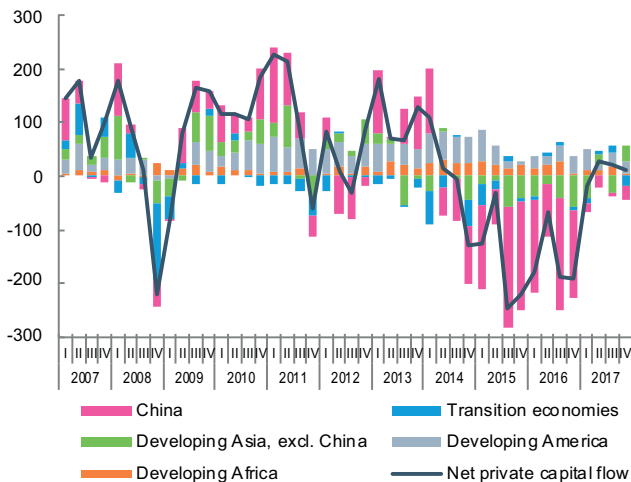
The broader context to south-south initiatives is that countries recognize they need an international financial system that will enable the real, structural transformation of the economy. Even with the south-south banks, funds and other mechanisms, it still means there needs to be a move away from today’s excessively de-regulated, footloose and unstable system (often called a non-system) that brings both feast and famine in terms of finance. The current architecture provokes massive, destabilizing and short-term capital flows that bring little if any long-term investment at the cost of a lot of exchange rate volatility, as flows enter and exit abruptly according to policy changes in the north not the needs of countries in the south. As shown in Chart 1, from the Trade and Development Report (TDR) 2018, there has been massive growth in capital flows and in their volatility following the quantitative easing policies after the economic crisis of 2007-2008. Developing countries cannot rely on a system like this to deliver liquidity in times of crisis – rather, it is potentially making the germ of a new crisis – and moreover



it does not bring long-term investment that is needed either. The flows in this chart are mostly into portfolio funds that flick in and out of countries very quickly. Their magnitude can be enormous – totalling \$190 billion dollars in net outflows just in the last quarter of 2016 – and yet they cannot be relied upon to stay for just a few months let along the years and even decades that infrastructure and industry require. Maturity mismatches mean there is a dearth of long-term finance at the same time as too much in the very short-term. (Foreign exchange volatility related to these flows creates another set of extreme problems, that is not discussed in this compendium.)

This surplus of short-term capital and dearth of long-term investment finance matters greatly for structural transformation and development because the financing needs to kick-start and sustain it are larger than they used to be. Catching up costs more nowadays, because the capital investments needed are more costly than they were at previous periods in history when today’s industrialised countries made their leap. Moreover, even if development finance was forthcoming, South-South financial mechanisms need to address the way that countries participate in global value chains, these being a predominant form of economic integration in the global economy for many developing countries. Only a few countries have achieved the benefits from GVCs that were expected, in terms of jobs created, value-added etc. Ideally, there would be a positive cycle whereby as the share of foreign valued added in manufacturing rises,

**Chart 1 Ballooning net capital flows 2007-2017**



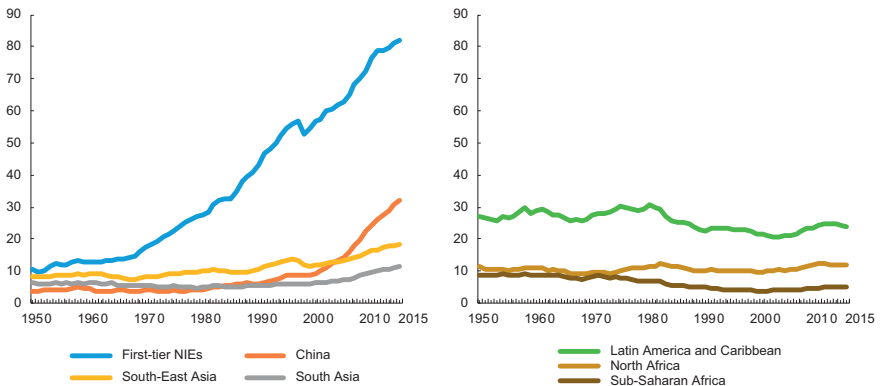
Source: UNCTAD TDR (2018:5).

there would be a comparable increase in manufacturing as a proportion of total GDP. Some Asian countries have been able to achieve this, which is why they are catching up faster (as shown in the chart below), but we are not seeing this in other developing economies (TDR 2016, p. 120).

Together, these trends mean that catching up is much more difficult than it used to be. The probability of a medium income country catching up with a high income country fell from 18% during the period 1950-1980 to just 8% during the period 1981-2010. Moreover, the chance of falling backward, of going from medium income to low-income has almost doubled from 12% to 21% over the same periods. In fact, only Asia and in particular China has made significant climb in terms of catching up (See Chart 2 below, and TDR 2016, p. 39). So the stakes are very high and it is not surprising that Southern led initiatives are flourishing as countries seek more and different ways to finance long-term economic transformation.

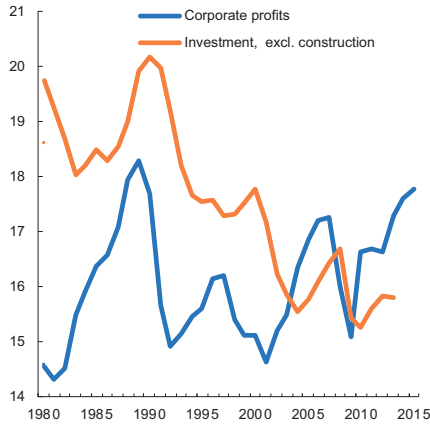
One challenge, even with the new development banks that are emerging or the old ones that are expanding, is their continued focus on partnering with the private sector, because no banks are sufficiently financed to do the heavily lifting on their own. It has long been clear that developing countries cannot rely on private investment to make the commitment to finance the infrastructure and other essentials needed for sustainable economic transformation. This requires extremely large investments in activities that will either be risky, low-profit, or even zero profit when accounted only in narrow financial terms. Unfortunately, recent years' experience is that the private sector is not even

**Chart 2 Catching up is harder than it used to be, 1950-2015**



Source: UNCTAD TDR (2016:39).

**Chart 3 Corporate profits and investment (excl. construction), 1980-2015**  
(Per cent of GDP)



Source: UNCTAD TDR (2016:143).

**Table 1 Falling investment to profit ratio – selected developing countries 1994-2014**

	Investment to profits (aggregate ratio)		
	1995-2002	2003-2008	2009-2014
Argentina	121.2	91.9	104.9
Brazil	178.2	104.3	79.8
Chile	107.2	109.5	92.7
China	131.1	164.9	105.7
India	122.0	127.5	114.3
Indonesia	109.8	89.4	81.0
Malaysia	88.8	72.3	55.3
Mexico	98.2	92.4	89.2
Rep. of Korea	287.8	103.6	106.8
Russian Fed.	217.7	134.0	83.2
South Africa	83.3	73.4	65.8
Thailand	84.6	71.5	58.9
Turkey	138.9	73.1	69.1

Source: UNCTAD TDR (2016:156).

investing sufficiently in activities that are profitable so it seems unlikely they would invest in activities that are loss-making from the start, or where profits are slow and risky. Compared to earlier periods of history, profits seem to have lost their positive and virtuous link with investment. It is no longer the case that profit is a dynamic incentive to re-invest (Chart 3). This relationship has particularly weakened since the 1980s -- especially in advanced economies, but in the developing economies as well, where the investment to profit ratio for all of the major developing economies fell from the 1990s compared to 2014. As shown in Table 1, some countries experienced worse falls than others, but the point is that across the board, private sector investment is too low.

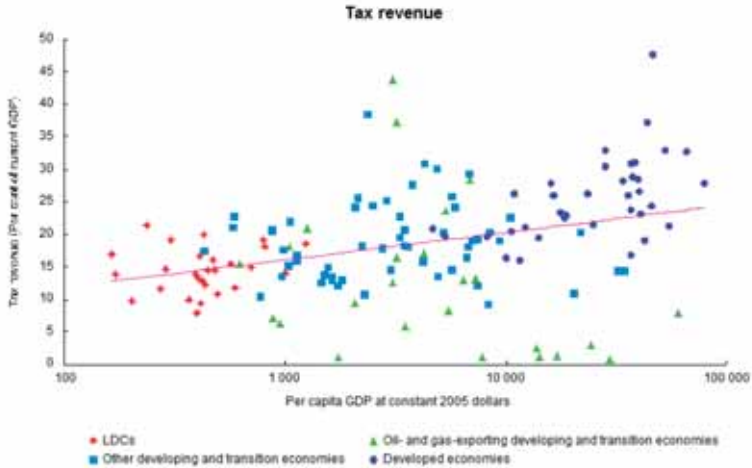
South-south development banks can help but, cannot solve this problem on their own because it stems from the very financial structure of the economy. Our model of the business sector, where managerial rewards are linked to short-term financial performance rather than the long-term, discourages much productive investment. A related problem for the new development banks and funds is that there is currently no commonly used metric for measuring their performance, other than the narrow financial standards used by most Credit Rating Agencies. Banks depend upon this as long as they continue to depend on raising capital on international markets for re-lending on to their clients. And yet, CRAs are not neutral in their ratings – UNCTAD evidence finds a systematic bias from the Big Three international credit raters that down-graded countries that had more heterodox policies and upgraded countries with ‘mainstream’ ones’ (TDR 2016), irrespective of underlying fundamentals of the economy. These ratings affect the amount that development banks can borrow and the capital cost – which impacts on their ability to lend. Also, bank officers may become wary of projects they know will not appeal to international investors and rating agencies, regardless of the needs of the country.

How can the new south-south funds and banks challenge these long-standing pressures? Given the evidence that private investors are reluctant to invest even in profitable activities, and that CRAs do not value socially worthwhile activities, it seems likely there will be little joy in Public Private Partnerships, even without all of the other concerns usually raised about this form of blended financing mechanism. Moreover, PPPs that include the private sector and development banks do not mean the burden is off the State. For starters, there is very little PPP presence in sectors such as water; similarly the geographical spread of investment is very uneven with the most needy areas being the least served. Even in the limited and uneven cases that PPPs do cover, typically the State still funded the lion’s share of the construction costs. On average, of these projects, 70% of the total investment is in the form of public debt and public equity (TDR 2016). And this is even before the issue of what happens once the project is up and running, when the State can incur significant fiscal obligations and contingent liabilities.

Furthermore, the State can be supportive in other more developmental ways, going beyond the obvious role of finance. There is a link between industrial policy and development banking that is often neglected, but big infrastructure projects create important opportunities where the State and development banks can work together to promote job creation, skills upgrading and technological transfer, using the window of State procurement. This kind of strategic collaboration has occurred in some parts of the developing world, but could be carried out more systematically and in areas that are high employers. The SDGs are essentially a massive investment and infrastructure vision of the future and there is potential to finance it through regional mechanisms and new development banks, and this opportunity could be made so much more developmental by thinking also about who is going to build it, who is going to create that economic hardware of airports and transport and hydroelectric power stations, the software of knowledge, management, design capabilities, and of course monitoring and regulation. As consumer of last resort the State can help guide and promote the firms in host countries to provide the supply services as well. There are many elements of this to consider but to take just one, this means that amidst all the discussions about new development banks and new regional financial and monetary mechanisms, we should also invest in public capacity. Governments need to invest in the capacities of their Ministries of energy and trade and industry, and finance and procurement, so that they can be strong partners alongside the new regional financing mechanisms.

This new goal reinforces the already-existing need to boost or maintain fiscal space - because how else will there be sufficient funds to pay for this. So, alongside the efforts to promote regional development banks, reserve funds and payment mechanisms, regional initiatives to boost fiscal space are also needed. South-South collaboration can help to stop the 'race to the bottom' that occurs when countries compete to offer ever more attractive tax packages to investors, and can help staunch the bleeding caused by tax caves or incorrect transfer pricing of TNCs. This is too difficult for one country to do alone - it takes solidarity and working together, because otherwise investors and illicit flows will just flood into the easiest domaine. To support this argument, Chart 4 shows a positive virtuous link between fiscal space and economic growth. Today's advanced economies are collecting and spending 50% or 45% of GDP in terms of public revenue, but they did not start like that. One hundred or more years ago they were collecting just 8 % or 10 % and had very little fiscal space indeed. But higher public revenues enabled them to put in place the social and physical infrastructure and investments needed for transformation and development. Which gets us back to the importance of south-south cooperation to support - rather than undermine - national goals for increasing fiscal capacity.

## Chart 4 Rising fiscal space goes hand in hand with rising GDP



Source: UNCTAD TDR (2014:165).

To sum up, these exciting new south-south mechanisms that are emerging rely upon a strong counterpart in the State to be a solid developmental partner. This will mean using the solidarity of the stake-holders, the owners of south-south mechanisms, to support a developmental, regional approach to investment and structural transformation. This includes regional projects but actually it goes beyond 'projects' and requires a joined-up thinking that integrates business, government, infrastructure, industry and trade, fiscal policy and technology policy. It also requires an expansionary macroeconomic framework overarching it all, that aims to boost aggregate demand as part and parcel of the whole plan. Moreover, as long as there continues to be low or uncertain aggregate demand in the north, this reinforces the need for south-south mechanisms to find new opportunities and directions, and a new scope and a new scale. Aggregate demand is also boosted when developing countries invest in their own regions, and in their own infrastructure and productive enterprises. Finally, while the south-south mechanisms offer a great deal of potential both for financing of development and for increasing 'voice', we should remember they do not take away the underlying need for a better, stronger and more inclusive global financial architecture.

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### 3. Asian experiences in financial initiatives and institution building – developmental and defensive

*Mah Hui Lim*<sup>1</sup>

The Asian effort of regional self-help came about because of the 1997 Asian financial crisis that was less of a boom-and-bust business cycle and more of a result of speculative capital flows coming into Asia in the early 1990s and then leaving abruptly. Particularly, of course, because of financial deregulations, there was financial liberalization that created a lot of systemic problems. And out of that many countries went into deep recession. Japan in 1997 then proposed a US\$100 billion Asian monetary fund which the United States and IMF vehemently rejected; the reasons given were they did not want to encourage countries to go around shopping for loans for fear that some countries or financial institutions might be more lax and encourage more hazard. But essentially the United States and IMF do not want the rest of the world to challenge their international financial and monetary authority. Indonesia, Thailand, the Republic of Korea, and Malaysia accepted the help of IMF. At that time in 1997 I was working with Deutsche Bank and was sent to Indonesia, that was badly affected by the crisis, to do debt restructuring. Deutsche Bank at that time had about US\$1 billion loans to Indonesia, of which we had to make loan loss provision of something like 90%. But eventually it had higher recovery rates. Malaysia, my country, accepted the IMF program initially, even though it didn't need financial injection of funds. But after 6 months they decided that was the wrong course, and moved in the other direction. The countries that accept IMF program like Indonesia and Thailand were very unhappy with the IMF restructuring and conditionalities imposed. The IMF policies worsened the countries' economic recession and unemployment. Subsequently there was a search among the Asian countries for alternatives.

They were searching for a regional financial architecture. There are two pillars to the regional financial architecture: a **defensive pillar** and a **developmental pillar**. Under the defensive pillar there are three prongs to it. First is Preventive, the second is Crisis Management and the third is Crisis Resolution. Under the developmental agenda you

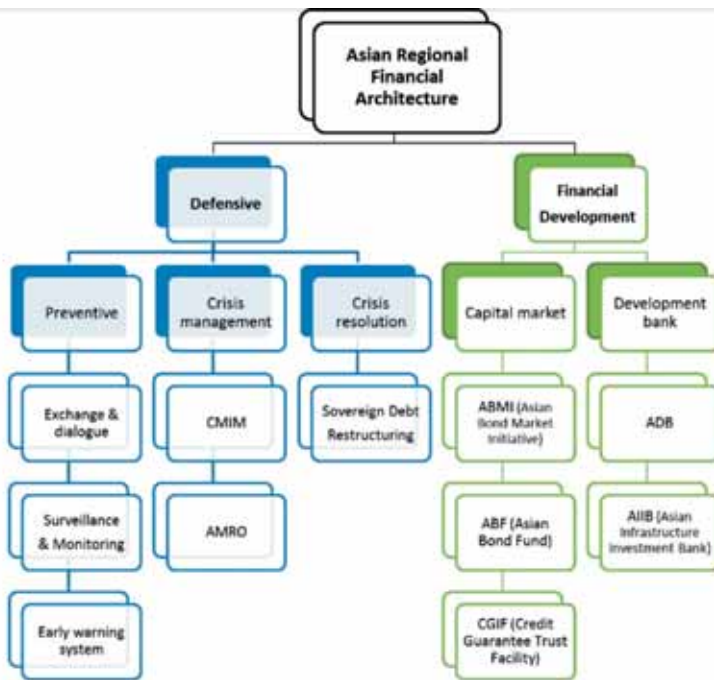
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<sup>1</sup> This paper draws upon presentations given by Dr Mah Hui Lim in Quito, Ecuador; Johannesburg, South Africa, and a background paper titled "Towards a regional financial architecture: the East Asian experience".



have the development of capital markets that has been pushed by ADB and many international financial institutions (IFIs), and the development banks. (see chart 1 below). Capital markets are a way of potentially providing long-term finance through indirect means, whereas development banks provide it directly. As I will show below, in the Asian example development banks have played a more important role than capital markets.

**Chart 1 Asia’s search for Regional Financial Architecture**



Note: Acronyms in the chart. ABMI – Asian Bond Market Initiative. ABF – Asian Bond Fund. ADB – Asian Development bank. AIIC – Asian Infrastructure Investment Bank. CGIF – Credit Guarantee and Investment Fund. In the preventative pillar is the AMRO – ASEAN+3 Macroeconomic Research Organisation and CMIM – Chiang Mai Initiative Multilateralisation. This brief note focuses on the Developmental Pillar – which aimed to broaden and deepen the financial system. (For discussion on the Preventative pillar, see Lim 2018 in Barrowclough, Gallagher and Kozul-Wright (2018).

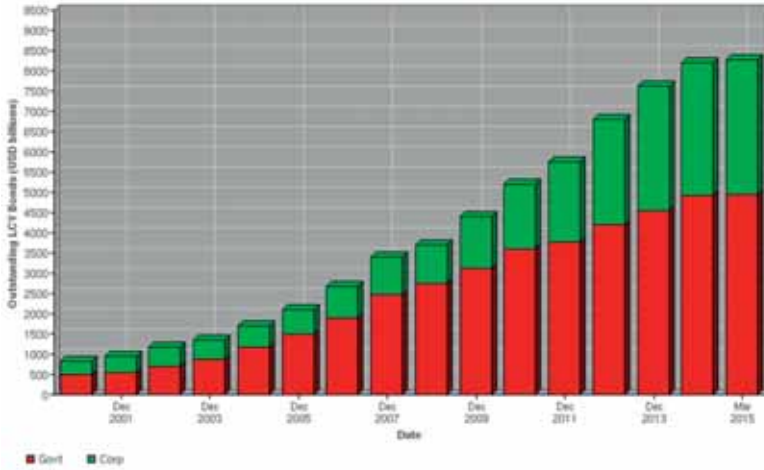
### *Regional bond markets*

Following the Asian Financial crisis, the thrust was to develop capital markets (stock and bond markets) to correct the dominance or overreliance of the Asian financial system on banks (which had constituted over 80% of the financial system in most of these countries, while bond markets were under-developed). It was held that banks made short-term loans not suited for capital development, especially infrastructure that required long term funding. The maturity mismatch was aggravated when loans were made in foreign currency, to fund local currency investments, contributing also to currency mismatch. The solution international financial institutions promoted was the development of local currency bond markets, which were believed to promote regional financial stability. They were also seen as a way to recycle the massive foreign reserves accumulated in the region.

ASEAN+3FM in 2003 endorsed the Asian Bond Markets Initiative, to mobilise Asian region savings for Asian investments. The first Asian Bond Fund was launched in 2003, harnessing the official reserves of Asian governments and a second, a local currency bond, followed in 2004. In 2008, the 11<sup>th</sup> ASEAN +3FM meeting agreed on a new roadmap to further develop regional bond markets, and in 2010 the ASEAB +3 Bond Market Forum met to discuss how to harmonize regulations and market practices for a regional bond market. Another important instrument promoting the bond market was a bond guarantee company established in 2010, set up as a trust fund of the Asian Development bank, which was supporting this whole initiative. It provided guarantees for local currency denominated bonds issued by companies in the countries of the region. There is still no regional rating agency, but ratings by domestic rating agencies or each country or international rating agencies like S&P were used, and by 2014, the CGIF had guaranteed bonds of seven countries from Indonesia, Singapore, Thailand and Viet Nam with a total outstanding guarantees of \$740 million. The East Asian local currency bond markets, excluding Japan, rose ten-fold over the past 15-years from \$836 billion to \$8.3 trillion. Of this, 60% were government bonds and 40% corporate.

However, this does not mean that the financial integration made possible through this regional bond market will create the benefits hoped for. There are many challenges with financial integration. Firstly is the general problem that there is little conclusive empirical evidence to link free capital mobility with faster economic growth. An IMF study (WP12/161) in fact shows that the relationship between financial development and economic growth is U-shaped. Finance has a positive effect in the early phase, but when it is over-developed the effect can be negative. Similarly, a working paper by the Asian Development bank (ADB WP 441) from 2015 shows that the relationship

**Chart 2 Growth of Asian local currency bond markets (excluding Japan)**



between financial development and inequality is U-shaped – financial development (as measured by proxies such as the ratio of private credit or liquid liabilities to GDP) has a positive effect on inequality in the early phase but this can then also turn negative when financialisation has become over-developed. Moreover, when using the measure of stock market capitalization as a proxy for financial development, it is positively correlated with inequality at all levels. As shown in chart 2 stock market capitalization for ASEAN countries has been rising over the last decade. In addition, freeing capital markets is linked with rising exposure to volatility, and vulnerability to external shocks. Equity and bond markets are predicated on the idea of a free capital market, with the ability to buy and sell instantaneously, to be able to dip in and out of markets. In turn, this leads to extreme volatility in asset prices and local currencies. Hence the push to deepen capital markets in smaller economies in the region, and to further integrate into global financial system, is increasing the vulnerability of those countries.

In particular, there is an important fallacy of composition concerning local currency bond markets. The idea that these solve currency exposure problems, simply because the bonds are denominated in local currencies, is actually a myth. Local currency bonds solve the currency mismatch only at the level of individual borrowers – they shift the currency risk to investors. This does not remove the risk and indeed the currency risks are not transmitted to the economy as a whole, creating a systemic risk. In times of

euphoric exuberance, foreign investors bussing local currency bonds and stocks can result in currency appreciation. The reverse happens in times of crisis, when foreign investors dump local currency bonds, sending local currencies spiraling downwards. This is happening now as emerging markets brace for the prospect of rising interest rates in the United States. Hence, the problem of 'original sin' remains.

The Asian economies have not been able to sustain massive capital flight, whether initiating in bond or equity markets, without serious negative effects on their real economy. This is one of the dark sides of capital markets that Keynes highlighted. To quote him "...with the development of organised investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but sometimes adds greatly of the instability of the system". Unfortunately, mainstream literature on bond market development in Asia ignores this problem.

The Malaysian experience is an example of this. Malaysia's financial master plan and capital market master plan are aimed at liberalising the financial sector and deepening integration into the global system. It has liberalised capital flows and encouraged outward capital flows for residents. It has developed one of the largest and deepest bond markets in SE Asia. Non residents now own 30%-50% of Asian government bonds, and 25% to 30% of equity markets. The rapid capital inflow led to the Ringgit appreciating – then the reverse. The Ringgit plunged from a high of RM3 to the US\$ in 2013/4 to RM4.5 by November 2015. Malaysia's external debt at 128% of reserves is one of the highest of emerging economies, making it most vulnerable. Although Malaysia fulfilled most of the necessary requirements and conditions for financial integration, it became more, not less vulnerable to external shocks. It had not adequately tapped its domestic savings, and financing for development.

### *Regional development banking*<sup>2</sup>

One of the main lessons from the discussion above is that too much finance can be risky and harmful. In the examples where capital markets have been used successfully, such as in Japan and the Republic of Korea, the financial system and capital flows were regulated. There was also a selective bias towards industrial policy – so that finance could play its supportive role. But even then, financial deregulation and financial services liberalization led to financial crisis – for Japan in 1991 and for the Republic of Korea in 1997.

In their zeal to correct Asian economies over-dependence on banking system, mainstream economists have overlooked the risks associated with financing through

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<sup>2</sup> This discussion is derived from the author's earlier paper (see Lim and Lim, 2012).

bond and stock issuance, and neglected to understand the critical role that development and long-term credit banks played in the economic development of countries like Japan, the Republic of Korea, and Germany. During the rapid industrialization of Japan after World War II, Japanese companies depended on private banks and public postal banks to provide financing. Corporations maintained close ties with banks that were enhanced through cross holding of shares, a system designed to achieve stable, long-term relationship and performance rather than short-term, transactional business to maximize profit (Cargill and Royama, 1988:43-48). Long-term credit banks and trust banks working closely with the government-owned Japanese Development Bank were the main providers of capital, lending to targeted industries like iron and steel, railway and shipping, coals as well as manufacturing industries like chemicals, cement, and textile. To mitigate against information asymmetry and credit risks, these banks built up in-depth credit knowledge of customers and even sent staff to work in their companies for extended period.

Other recent experiences of successful use of public institutions for long-term development include the European Investment Bank (EIB), the Bank of North Dakota (BND), and the Brazilian Development Bank (BNDES).<sup>3</sup> These institutions are well managed and focused on long-term funding, are not into speculative investments, and not obsessed with high and unsustainable rates of return. They have managed better over the period of the global financial crisis than the Anglo-American commercial/investment banking models. Similarly, a reason why Canada did not suffer a banking crisis in 2008 or even earlier in the 19<sup>th</sup> and 20<sup>th</sup> century is that the federal government could charter nation-wide banks and allowed a few large banks to function in an oligopolistic but well-regulated manner. While these may be slow on innovation, they had the advantage of preserving financial stability; there were many instances of bank failures but few that led to bank panics and crisis as in other parts of the world where state banks were weak and fragmented, under-regulated, and a shadow financial system created the conditions for recurrent financial instability.

The promotion of long-term development banks at both a regional and national level should be a pillar of the regional financial architecture. Unfortunately this has not always been given much attention. At present, the only development bank in Asia is the ADB. The size of ADB is small compared to that of EIB and BNDES. The value of loans disbursed by ADB was US\$ 10 billion compared to Euro 64 billion (US\$ 80 billion) for EIB and Real 156 billion (US\$ 78 billion) for BNDES.

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<sup>3</sup> For more detailed discussion of these institutions, see Lim and Lim (2012: 40-44).

Furthermore, ADB, dominated by Japan and the United States, each with 13% voting rights, follows closely the World Bank and IMF models of operation, while China has only 5.5% voting rights. Frustrated by the unbalanced governance structure and the slow pace of reform coming from United States resistance to give China a greater voice in international financial institutions, China in 2013 floated the idea of setting up a new regional/international financial institution.<sup>4</sup> This new organization aims to finance the huge infrastructure investments requirements in Asia, estimated by an ADB study at \$800 billion annually from 2010-2020. With great speed, characteristic of the Chinese, they managed to gather 21 countries to sign a memorandum of understanding to set up the Asian Infrastructure Investment Bank (AIIB) in October 2014. Despite strong objections and pressure from the United States, countries closely allied to the United States, like Australia, the Republic of Korea and the United Kingdom, joined the AIIB. As of April 2015, 57 countries signed up as prospective founding members. Japan and the United States did not join the bandwagon (Wikipedia). The proposed authorized capital of AIIB is set at \$100 billion.

If the failure of Asia to set up the Asian Monetary Fund in 1997, a result of United States objection, is indicative of United States dominance over the international financial architecture, China's success in establishing the AIIB in 2015, despite strong United States resistance, signals the declining influence of the United States, in the international financial system.

There is room for healthy competition in the field of development banks. The AIIB is focused only on financing large-scale infrastructure projects. There are other fields that are equally important to promote and finance in Asia. Among these are small and medium size enterprises (SMEs) and micro-finance. SMEs make up the overwhelming majority of business enterprises by numbers in Asia. For example, SMEs make up 98.5% of businesses, and contribute 31% of GDP and 59% of employment in Malaysia (Poo, 2013). Yet most are starved of financing. Only 45 % of total bank loans in the country go to businesses while 55% goes to financing household debt; and most business loans go to large or listed companies. Large scale financing from banks or from bond markets often does not reach small medium enterprises. Yet, they provide the largest amount of employment for the people. Regional and national development banks should be set up to meet the needs of these businesses. There are recent calls by the ASEAN Business Advisory Council Chairman to set up a regional bank for micro, small and medium enterprises.

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<sup>4</sup> Bernanke said the reluctance of the United States Congress to grant China a greater say in international financial institutions pushed China into establishing the AIIB (Pilling and Noble, 2015).

### *A new business model*

Equally important, the new financial architecture should not simply follow the dominant EVA (economic value added) business model in the market place. The EVA model preaches that the only and sole objective of a business is to maximize shareholders value. All other objectives like meeting consumers' needs, taking care of employees' welfare, providing high quality products, contributing to corporate governance, and meeting social responsibility are peripheral. This incentive structure also encourages the banker to maximize short-term rewards without regard to long-term risks and consequences (see Lim and Lim, 2010; 54–58). While there is little quarrel over the need for a project or enterprise to yield positive net present value, the larger question is what is an acceptable level of profit? Should profit be maximized at the expense of public good? This problem is particularly acute for the banking and financial industry. Banks are in the business of financial intermediation; they borrow to lend, borrowing and lending many times their capital. In the period preceding the Great Financial Crisis, United States banks, especially investment banks, were leveraged up to 40 times their capital; the higher the leverage, the higher the return on capital, but the greater the risks. The era of light regulation gave banks and financial institutions the golden opportunity to cut corners, to over-leverage, and to engage in risky businesses in order to achieve the objective of maximizing return to shareholders. The result was the greatest financial crisis since the Great Depression.

This business model is unsustainable and generates high social and economic costs. The limits of this model are beginning to be questioned by not only some business schools but also prominent businessmen. Ho Kwon Ping, a leading businessman in Singapore and also the chairman of the board of trustee of Singapore Management University, in a speech to an international business conference, advocated a shift away from the profit-maximization model to a more balanced performance model that takes account the interests of other stakeholders (Ho, 2011). If leaders in the private sector recognize the limits of the EVA business model and the need to develop alternative business models, what more for public corporations and institutions.

The regional and national development banks in the new financial architecture should adopt the concept of socially acceptable rate of return rather than that of maximizing shareholders return. These banks should undertake projects that are financially sound, ecologically sustainable, promote long-run stable growth and are welfare maximizing. Governments should pool their resources to fund these banks and set the broad objectives for these institutions. They should then hire professionals to manage them

in accordance with those objectives and guidelines. Thereafter, there should be no political interference in the day-to-day management. The best practices of corporate governance in the private and public sectors should be combined.

## Conclusion

The post Bretton Woods international financial system marked by financial deregulation and liberalization resulted in free capital flows and floating exchange rate system for many countries. Volatile capital flows have heightened financial instability and led to financial crises in many parts of emerging market economies. The failure of the current international financial architecture to assist Asia resolve the AFC in the late 1990s, particularly the objection by the United States and IMF to establish an Asian liquidity support fund, pushed these countries to find a regional solution to the problem.

In terms of the developmental objective in Asia's regional financial architecture, most of the effort is towards developing local currency bond markets to tap the large amount of foreign reserves held by Asian countries and to promote closer regional financial integration. In their zeal to promote bond markets, the risks of greater financial instability associated with capital markets are overlooked. We propose that attention be given to develop another pillar of a regional financial architecture, i.e., the establishment of long-term regional and national development banks as means to promote stable and long-term growth with less risk of volatile capital flows.

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## 4. Financing strategies from UNASUR: An assessment

*Pedro Silva Barros*

In this piece I present the economic agenda of the Union of South American Nations UNASUR, emphasize some points regarding financial integration and make some comments on the South American Council of Economy and Finance that works directly with the subject of integration. We believe that the challenge of expanding and improving our funding instruments should be at the heart of the regional dialogue at this time.

Much has been discussed about how, during the bonanza decade in South America (2003-2012), there was great progress in reducing poverty, little in reducing income inequality and nothing in wealth inequality. To a greater or lesser extent, this phenomenon is common in most of South America. However, in relation to trade, production and financial integration, the debate has been less intense. In the ten years mentioned, important advances were made in trade and consumption, a little in infrastructure and productivity, and almost nothing in productive and financial integration. Today, the economic agenda of UNASUR takes this context into account, much more so now than when UNASUR was created.

### *The economic context of South America*

There is a low dynamism in the South American economy, with Brazil having recorded the main recession in its history with rising unemployment. Venezuela and Argentina are respectively in the first and second places among the countries with the highest inflation rates in the world. The limited intraregional trade has been structural, a regional feature that has persisted despite the last decade of the economic expansion. In late 2016, ECLAC presented its report on the international insertion of the Latin American region,<sup>1</sup> showing very strong deterioration of intra-regional trade: 20 per cent less of intra-regional trade in 2015 than the year before.

The decline in Latin-American intra-regional trade and the changes in its foreign trade patterns more generally away from manufacturing is unprecedented. The case of Brazil is especially serious. More than 80 per cent of what it exports to the Latin American region is manufactured. Of what it exports to the United States of America, slightly more than 50 per cent is manufactured, to Europe 35 per cent and China, only 5 per cent. In 2016, despite the fact that Brazil's trade balance generated a global surplus, Brazil registered its largest deficit in the sectoral balance of machinery and equipment in history. Intraregional

<sup>1</sup> Available at: [http://repositorio.cepal.org/bitstream/handle/11362/40744/1/S1601274\\_es.pdf](http://repositorio.cepal.org/bitstream/handle/11362/40744/1/S1601274_es.pdf).

trade is the one that declined most, as in 2014 and 2015, mainly with South America. This is unfortunate, given that, compared to our region's trade with the rest of the world, intra-regional trade is more diversified and more intensive in manufacturing. It has more technological content, is more accessible to SMEs and creates relatively more and better jobs. That is, it promotes much more positive social externalities.

The bonanza of the years 2003-2012 was used to greatly improve the indicators of poverty and little those of inequality. But there were no other structural changes, such as in taxes or in the long-term financing instruments. Today, the region is paying for this omission and faces the risk of losing the social improvements experienced in the last decade.

South American countries have a major deficiency in infrastructure and investments in this sector are low relative to other emerging countries. Although there have been some important integration projects in the last decade, such as the first bridges between Brazil and Peru and Guyana, regional investment in infrastructure in South America as a proportion of GDP is half the average for emerging countries and one-fourth of China. It is estimated that the region would need investment in infrastructure equivalent to 8 per cent of GDP to be competitive in logistics. In the last decade, it did not even reach 2 per cent. Moreover, only a small fraction of what is invested in infrastructure in South America is related to integration projects. It is much cheaper to ship a container from the Manta port in Ecuador to Shanghai in China than to Santos in Brazil.

The countries of the region follow quite different economic models of integration between themselves. These differences were quite not as clear as when the UNASUR structure was organized. Our organization works with a vision of consensus, so the most important challenge nowadays is to reconcile these different models of insertion into a common agenda and actions. Looking back, what is seen is that there has not been much progress on some issues, there were achievements in others, but now we need to make special progress on financial cooperation. For better or for worse, the history of South America shows that we move much more by necessity than by affinities. This may bring some optimism for the next period, as everything indicates that it will be worse than the previous one. In this sense I am optimistic because the need will make the countries of the region work together, especially on the financial issues.

### *Instruments for regional integration*

Various instruments of integration have been proposed at a time when there was apparently a greater confluence among governments in the region, but not all were implemented with the speed and consistency desired. The challenge now is to reconcile divergent international economic and integration policies with the need to stop the fall of intraregional

trade and stimulate regional value chains. The Bank of the South, discussed extensively in this volume, can be a key instrument in supporting the development of such chains and thus become a strategic tool for integration and for overcoming the unprecedented crisis facing the region. The fact is that there is a permanent concern among those who work prioritarily on integration issues, that little progress has been made. As Cassou notes in this volume, the IADB board determined that 15 per cent of its project funding should go to integration projects involving more than two countries. Although the objective is being met, it is evident that the volume is very low compared to the needs of the region.

Integration and multi-jurisdictional projects involve risks, hampering access to financing and requiring the use of financial cooperation instruments to facilitate and mitigate their risks. The current situation of fiscal consolidation disproportionately affects public investment, even because traditional risk and profitability criteria hamper the most necessary projects for integration. Those that would make productive integration of the region viable are projects that have a very long-term return. Let us think that half the area of the region is Amazonian. The integration of this area will not bring the return in a time compatible with other projects that these banks generally finance. For example, a project in a metropolitan water authority has a much faster return than large integration projects.

There is a consensus in the diagnosis on why only 18 per cent of international trade in South America is intraregional: weakness in infrastructure and deficiencies in financing and guarantees. I believe that the central objective of the Bank of the South will be to work on these two weaknesses in order to raise intraregional trade and integration. This also applies to the local currency payment system. Regional institutions working to facilitate intra-regional trade, such as ALADI and SUCRE, have already been invited to the meetings of both the South American Council of Economics and Finance and its Working Group on Financial Integration. All of them have a clear idea about complementarity. The same is true for the CAF and the IADB in infrastructure and development finance.

### *Social Value Chains: an agenda to overcome the crisis*

More than ever, regional articulation is needed to strengthen financial cooperation for both infrastructure and the generation of regional production chains. In the General Secretariat under the guidance of our secretary, former President Ernesto Samper, we worked with the concept of *value social chains*, as the articulating axis of the economic agenda in UNASUR. Although there have been advances in work on value chains at different international and academic institutions, there have been limitations as well, particularly concerning the social impacts of the insertion of South America into these global value chains. All agree on one thing: there is a great weakness in South America regarding the insertion in these chains.

It is in this critical context that we are structuring the economic agenda in UNASUR. UNASUR is almost 9 years old and some Councils were created later. The departments of UNASUR are only 1 year old. I represent the Direction of Economic Affairs. There are four others: social affairs, politics and defense, citizen security and justice, and cooperation.

The idea of social networks is about articulating the entire economic agenda of UNASUR, guarantee spaces for the development of common public policies and pursue joint ventures. The basic definition of social networks is that they are productive chains with broad social externalities and with great potential for regional integration. Thus, creating social value chains through public policies in the countries of the region is expected to boost regional integration and strengthen our social network. Several goals are currently under the attention of the councils: adding value to natural resources, expanding intra-regional trade, and strengthening productive integration, border development, and public procurement with instruments such as the *Medicine Price Pool*. One of the main targeted sectors is *family agriculture*, which we work on with the REAF (Specialized Family Agriculture Network) of Mercosur.

### *The role of the UNASUR councils*

The **Council of Economy and Finance** has as an executive body the Working Group on Financial Integration (in Spanish GTIF). In the GTIF, there are two projects of our Fund of Common Initiatives of UNASUR (FIC). One is for the expansion of intraregional trade. It provides guarantees for intraregional exports and addresses commercial aspects of productive integration projects in the region. The other has to do with productive integration “Value chains and productive complementation of the countries of UNASUR: A diagnosis based on input-output matrices”. In 2015, after almost four years of work by ECLAC<sup>2</sup>, together with the Brazilian Institute of Applied Economic Research (IPEA), a long-term work was completed, which was about organizing an input-output matrix of the region. To some extent, the data were very different and incompatible. The idea is to deepen in this input-output matrix the sectors that have the most potential for productive integration.

COSIPLAN is the infrastructure and planning council of UNASUR. It is the legacy of IIRSA, the Initiative for the Integration of Regional Infrastructure in South America, which was created in 2000 and for many it was the beginning of UNASUR. In 2000, it was the first time in history that the 12 presidents of the region met without the presence of

<sup>2</sup> <http://www.cepal.org/es/publicaciones/40271-la-matriz-insumo-producto-america-sur-principales-supuestos-consideraciones>

other countries. The idea of UNASUR was to follow this path. In 2009, the presidents created the infrastructure and planning council to give it a political orientation, but took advantage of the existing institutions that formed IIRSA, then redefined as the technical arm of this Council.

COSIPLAN itself defined 31 priority projects of a portfolio of more than 500 projects. It is the consensus agenda of the 12 countries, and the General Secretariat works with more emphasis on supporting 8 projects, which are those involving 3 or more countries. For example, in Ecuador, one project is on a northeastern access to the Amazon basin through river transport.

#### *The Energy Council of South America*

The Energy Council of South America is the only council of the 12 of UNASUR that does not yet have a statute but considerable progress was made during 2016 regarding both the Statute and the South American Energy Treaty. With the support of OLADE, we have a map of the possibilities and needs of interconnections of the electric and gas networks of the region. This helps the South America's energy planning a lot and it is inevitable that the advance of discussions on energy integration at the ECS will require more articulation with financial institutions.

#### *The South American Council of Science, Technology and Innovation (COSUCTI)*

Finally, UNASUR has the COSUCTI. At present, work is being done on a diagnosis of science and technology policies and national innovation systems. The weakness of financing in this sector has already been identified in the initial studies.

## 5. The Political Economy of Global Financial Institutions and Responses from the South

*Theotonio dos Santos*

Since World War II, the structure of the world economy has undergone dramatic changes. As a result, a new world order is emerging. Using the purchasing power parity measure to rank national economies, the International Monetary Fund's World Economic Outlook Report of April 2016 shows that China is already the largest economy in the world, surpassing the United States, now ranked as the second largest. Also, IMF projections, though admittedly uncertain, show that in 2021 China will have a GDP worth \$30.7 trillion against a United States GDP of \$22.2 trillion. In that same year, India will be the third largest economy, Japan the fourth, then followed by Germany in fifth position, Russian Federation (sixth position) and, somewhat unexpectedly, Indonesia the seventh, surpassing Brazil, which then will be in eighth position. In this new configuration, old world great powers such as the United Kingdom and France will drop down the ranking from the high positions these economies held in the past.

These dramatic changes are taking place not only at the macro, but also at micro level. In 2007, just before the global financial crisis, half of the world's ten largest companies were already Chinese. Petro China, an oil company, was ranked first, followed by United States' Exxon, then General Electric, next followed by two more Chinese companies: China Mobile and the Industrial Bank of China. These were followed by United States' Microsoft, Russia's Gazprom, and then Shell, the only European company in the top 10. The other two companies in the top ten were China Petroleum and China life, the latter from the financial sector. Key features among China's top companies are the facts that they are state-owned and with global action, although they are still very much focused on China's domestic markets. As a reflection of this, such state-owned enterprises have great dominance in China's corporate sector and capital markets. This new configuration signals an increasing power of state-owned enterprises over the organization of the world economy, given China's growing global presence.

Two other aspects of China's growing dominance on the world stage are the country's large trade surpluses (at least until recently) and the amount of foreign reserves that the country has amassed, partly reflecting such surpluses, and partly due to net positive financial flows. This situation is to some extent mimicked by Middle East countries and in much of Asia as well. The result has been the emergence of powerful sovereign wealth funds, which are then purchasing companies around the world. Indeed, foreign reserves,

some of which forming Sovereign Wealth Funds (SWF), are being increasingly used in different ways, sometimes as investment tools, sometimes as a tool of intervention on international financial markets. China, in particular, is using part of these financial resources to back up the creation of international banks such as the AIIB and the NDB.

Interestingly, Brazil, also a country with relatively large international reserves, is prioritizing investment in United States government bonds and, unlike China, is eschewing from supporting as initially promised southern financial initiatives such the Bank of the South. Brazil's Central Bank preference for United States treasuries over a new development bank is disappointing, as the latter would hardly be a loss for the country; on the contrary, it would facilitate Brazilian companies to invest in different parts of the South American region. The mirror image of China's and Asia's trade surpluses has been the United States trade deficit, and the country's underlying fiscal deficits. The result has been growing United States' national debt, which has reached \$18 trillion more recently. The backdrop of these trends has been the opening of trade for China, which the country took advantage by exporting to the United States. But much of it has taken place through American companies, which have invested in China, attracted to the country's cheap labor force.

In this process, Latin American countries have over the years increased its trade engagement with China, which makes sense given China's growing economic power and demand for imports. However, growing engagement with China on the trade front should be viewed with caution, especially given that it has taken place on the basis of exports of raw materials rather than manufacturing goods. Given this trend, Brazil, which is a country with a relatively large industrial base, has engaged in trade with other Latin American countries as well, as these are countries to which Brazil has a market for its manufacturing goods. Brazil's growing trade with China and its continued engagement with Latin America is therefore not product of ideology. Instead, it reflects a new global economic reality and pragmatism.

Although energy demand is at the time of writing somewhat flat, it will grow rapidly in the coming years and two key drivers of energy demand going forward will be China and India. The growing demand that will ensue from these new superpowers will imply the need for renewable energy, which in turn will be associated with new technologies and expansion of products such as electric cars. New technologies will require new raw materials, one of which is lithium, 80 per cent of which is found in Bolivia. Another new material is niobium, which allows going to space, almost all of which is found in Brazil. Given this, it is vital that Latin American countries act strategically, and use institutions like UNASUR to have a unified position to be able to have a regional exploitation strategy

and enter global negotiations with a clear regional position. This takes us to a very important question: what financial structure should be put in place to support this sort of initiative? Hopefully, the Bank of the South, as well as the BRICS NDB, are institutions that can be key tools to this end, given the expertise they will hold in this and other vital issues.

Thinking about strategic action more broadly, about 15 years ago, I was in Bangkok, where I heard that, in Asia, monthly meetings take place with all ministers of the economy of Asia; also, more than 20 years of planning regional integration have taken place, with a vision about how each sector should evolve within a global planning for the whole region. The question is whether Latin America can, or not, emulate this type of initiative. For that, the Bank of the South certainly, again, is a step in the right direction. More generally, what we find today in Latin America and in meetings such as those organized by UNCTAD and UNASUR, are people from various sectors trying to help the region move towards regional integration, which can be a step forward for the advancement of humanity, a step away from actions that only serve as instruments to strengthen the interests of small groups completely oblivious of the destinies of the people of the region.





# PART 2: SOUTHERN-LED DEVELOPMENT BANKS AND THEIR ROLE



## 6. Development Banks from the South: Towards an Integrated Approach

*Ricardo Gottschalk*

As part of a new phase of south-south financial cooperation since the beginning of the 21<sup>st</sup> century, development banks at all levels — national, regional, sub-regional, international — have had a prominent role as key sources of additional development finance. That role came at an appropriate time, given the large sums of financing needed to support the 2030 Development Agenda and many of its 17 sustainable development goals (SDGs).

### *Why development banks*

Development banks can serve as effective institutional mechanisms to help finance the SDGs. This is because of their clear mandate to support development-oriented projects, their in-house expertise and their track record on identification, development, risk assessment and management of large and complex projects. These attributes are especially important for financing the many infrastructure projects embedded in the SDGs. Goal 9 is about building resilient infrastructure, promoting industrialization and fostering innovation, goal 6 emphasizes availability and sustainable management water and sanitation for all, goal 7 affordable and clean energy and goal 11 making cities inclusive, resilient and sustainable.

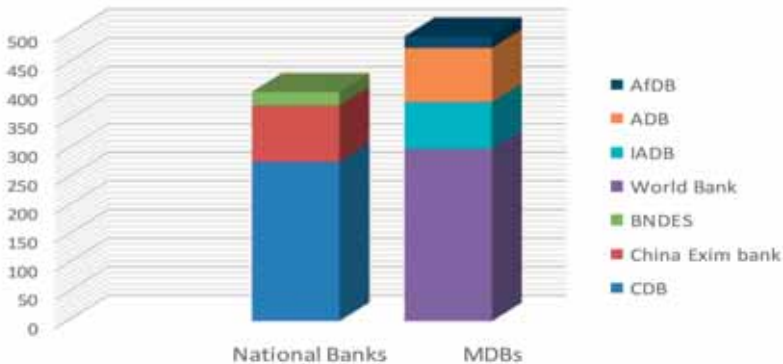
Historically, the large multilateral development banks – the World Bank, the Asian Development Bank (ADB), the Inter-American Development Bank (IADB) and the African Development Bank (AfDB) – have been major providers of finance for infrastructure and other development projects. However, their total annual loan disbursements, at \$78 billion in 2016 (UNCTAD, 2018), is very little when compared with the investment needs to meet developmental goals in the coming years. UNCTAD has estimated the annual financing gap in key sustainable development goals at \$2.5 trillion per year for the period 2015-2030 (UNCTAD, 2014: 142-145). These banks are gearing up efforts to expand their loan capacities, through balance sheet merges, loan portfolio optimization and capital increases. It is still to be seen, though, how effective these measures will be in the coming years.

### *The national development banks*

In the context of a renewed phase of south-south cooperation, national development banks have played a very important role by expanding vigorously their international operations. Chart 1 shows total international outstanding loans from the large MDBs, and from three national development banks: the Brazilian national development bank

BNDES<sup>1</sup>, the China Development Bank (CDB), and China's Exim bank, a bank that finances trade but which, in addition, has played a vital role as a development bank. These loans are very significant, reaching nearly \$100 billion in the case of China Exim bank and surpassing \$250 billion in the case of CDB. These loan values, both individually and in aggregate, are comparable in size with those of the large MDBs (chart 1).

**Chart 1 Total international loans, in US\$ billion 2016**



Source: Author's estimation, based on banks' annual reports. Note: WB: Sum of net outstanding loans of the IBRD and of the IDA, 2016 financial year; IADB: Outstanding loans of ordinary capital, fund for special operations and other funds; ADB: Outstanding loans of ordinary capital resources and ADF, as of 1 January 2017; AfDB: Net loans of AfDB only; China Exim bank: International cooperation loans only; CDB: International loans only; BNDES: values are merely indicative, based on loans in foreign currency.

Another interesting characteristic of these national banks is their geographic reach. The CDB and China's Exim Bank have provided finance to different countries from every developing region in the world: Africa, Asia and the Pacific and Latin America, and China's Exim bank has provided finance not just for trade but also for construction contracts and investment projects. Brazil's BNDES has offered loans to both Latin American and African countries, through its international operations built over time to support national companies doing business abroad, but also regional integration.

#### *The sub-regional development banks*

In this new south-south cooperation constellation, sub-regional development banks have too scaled up their operations significantly. In Latin America and the Caribbean,

<sup>1</sup> BNDES stands for *Banco Nacional de Desenvolvimento Econômico e Social*.

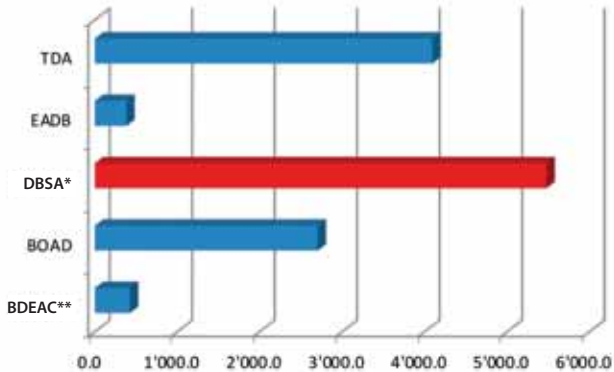
the Central American Bank for Economic Integration, the Caribbean Development Bank and the Latin American Development Bank, or CAF, have in recent past played an important financing role in the countries in which they operate. CAF in particular has been widely acknowledged as a very successful development bank, with a clear focus on infrastructure for regional integration, lean management structure, rapid loan approvals, and no conditionality attached (CAF, 2014).

In Africa, the region has several long-established, sub-regional development banks, with a very clear mandate to support southern initiatives, including regional integration. These banks are: The Central African States Development Bank (BDEAC), the West African Development Bank (BOAD), the Development Bank of Southern Africa (DBSA), the East African Development Bank (EADB), and the Trade and Development Bank (TDB), which is a development bank that covers the eastern and southern Africa. Among these banks, DBSA has been the most pro-active or at least the one whose loan portfolio is the biggest of all, and with presence in both South Africa and other African countries, thus operating regionally despite the fact it is solely owned by South Africa. The EADB and the BDEAC, meanwhile, are very small with total assets in their millions of dollars (chart 2), thus pointing to the need of thinking on how these various banks could be strengthened to become effective tools for development in a region that harbors the largest infrastructure deficits and developmental needs.

#### *The cross-south development banks*

Among the existing southern banks that operate across regions, it is worth noting the active role of the Islamic Development Bank (IsDB), a bank that has expanded its operations strongly in recent years. Wholly owned by the southern countries, the bank has an extensive geographic coverage, explained by its broad membership which includes countries from all major developing regions. As Abdelwahab discusses in this volume, IsDB operates on a solidarity basis, offering a wide range of products with no conditions attached. He also portrays the bank as flexible and adaptable, having a lean structure, with non-resident board. These are features the IsDB shares with both sub-regional banks such as CAF and the newly created banks BRICS NDB and AIIB, as will be seen below. Among the new banks, there is also the Bank of the South, which, despite its name, stands at present as a development bank serving countries in South America. The bank has yet to start its loan operations.

Among the new banks, the NDB started with a subscribed capital of 50 billion dollars, of which 20 per cent is paid in capital (BRICS, 2014 and 2015). Some calculations made at the time the bank was created suggested that, under a certain set of assumptions, the

**Chart 2 Sub-regional banks in Africa Total assets (\$ million, 2015)**

Source: Banks' annual reports. \* 31 March 2016. \*\* 31 Dec 2014.

bank could have a portfolio of loans of a reasonable size in a time frame of 10 years, if compared with all the largish development banks (Griffith-Jones, 2014). Indeed, NDB is currently working with a base scenario in which its loan disbursements are forecasted to grow from \$700 million in 2017 to 5.8 billion in 2021, reaching a portfolio of outstanding loans of \$14.6 billion at the end of that later year (NDB, 2017a: Table 2).

The NDB has a governance structure in which just the BRICS countries themselves are the shareholders, but, as stressed in Lima's article in this volume, plans are that membership will be expanded, thereby increasing its capital base and its loan capacity. In terms of geographic reach, the NDB plans to lend not just to the BRICS countries themselves but also to the countries of the regions where the BRICS countries belong. This essentially implies that the bank will cover every developing region in the world. An office has been already opened in South Africa and plans are to open additional ones in Brazil, India and Russia (NDB, 2017b). The bank, which has a non-resident board, claims in the *General Strategy* it laid out for the years 2017-2021 to aim at being 'fast, flexible and efficient' (NDB, 2017a:4) and to focus on sustainable infrastructure development, an area it identifies as deficient in the current development finance architecture. The key areas it aims to operate include: clean energy, transport infrastructure needed to connect people and markets, irrigation, water and sanitation, and sustainable urban development.

As for its proposed *modus operandi*, the NDB has set a clear aim to build links with other banks. Indeed, it began doing so as soon as it started its operations in early 2016, by approving projects in collaboration with both international and national development banks. Of course, it is important that, at some point, the NDB starts considering seriously about providing finance to low-income countries. In this scenario, concessional loans would be necessary, becoming part of the bank's total loan portfolio. In this regard, it is worth noting that the bank's articles of agreement allow for the establishment or administration of special funds, but, as such articles appear to suggest, these would be deployed specifically to support the bank in its task of mobilizing resources for sustainable infrastructure and to contribute to project preparation (NDB, 2017a). It is thus not clear if a special fund could also be created for provision of concessional loans to poorer borrowers.

The AIIB started larger, with authorized capital of \$100 billion and with many more members, from both Asia and other continents. The result is that, in terms of governance structure, the bank shareholders cover both developed and developing countries, but southern countries have veto power. Like the NDB and the IsDB, it has a non-resident board and has a clear focus on infrastructure development. According to its first president, the bank will be “clean, lean and green” and adhere to the highest international standards (Donnan and Sevastopulo, 2015).

The question is to what extent will all these new development banks be truly different from the existing development finance institutions? The answer is likely to be amply positive. Power is more equally distributed between shareholders, and with more voice from southern countries. This is an important difference from the existing institutions. Moreover, these new banks have a leaner structure and aim at being more agile, meaning that loan approvals can be made quicker, which is evidenced both by the AIIB and the NDB, which have started their operations in 2016 and approved several projects in the same year. Another very important difference is that these banks have no conditionality attached. This is a very important feature from the perspective of the South. In addition, they have a bigger focus on productive sectors as well as on regional integration. Finally, a further feature emerging from these institutions is that they are very keen to cooperate with other financial institutions. This is very important, as it signals a healthy buildup of a network of development banks, that would be working together and successfully supporting different development goals. This is welcome, since what development finance needs is an integrated approach whereby different sources and mechanisms of financing coexist and cooperate with one another. The new development banks, therefore, seem to be contributing positively to the creation

of a more integrated development finance system, and, hopefully, to the emergence of a new international financial architecture that is better equipped to meet the financing needs of inclusive and sustainable development.

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## 7. New financial institutions of development in uncertain times

*Rogério Studart*

In this article, I bring together some conclusions from recent study conducted with colleagues from Boston University and Brookings Institution, on the role of national development banks in the provision of finance and sustainability.

The first conclusion is that an inexplicable intellectual prejudice prevails against national and regional development banks. Their role is still underestimated by the vast majority of researchers. Many, for example, think that these institutions are only justified in “initial” situations of low national or regional economic development, especially of the domestic financial sector, and that their role is basically associated with market failures in developing economies. However, many development banks exist around the world, and large ones are found in emerging and developed countries. For example, the largest in the world is the China Development Bank (CDB), the second is the KfW in Germany, the third is the Korean Development Bank (KDB) and the fourth is the Brazilian BNDES.

The second conclusion is that there are reasons for the widespread existence of these institutions: national development banks always play a transformative role in fundamental moments in the history of all nations, including those already considered developed.

The third conclusion is that, at a time of profound uncertainty as the world is currently experiencing, it is not surprising that many countries are promoting the creation of new large development banks. In fact, new national development banks are being created in Europe, the United States, Japan and the Republic of Korea, while China leads on the creation of two large multilateral development banks. All these institutions are involved in supporting major national transformations.

The final conclusion is that there is a convergence of action of these institutions: all of them are focusing on the theme of infrastructure – and in particular, on “sustainable infrastructure”, which simultaneously promotes inclusive growth and long-term environmental sustainability. This means that the perception of much of the world is that the road to future development goes through this type of investment – that is, investments in sustainable infrastructure. These projects are of relevance not only for national but also for the global economy, since they can generate the necessary transformations both at national and global levels.

All this should come as no surprise: investment in sustainable infrastructure means confronting simultaneously the three great challenges that affect us all and all nations. The first is still that of poverty and inequality, whose confrontation has always been a moral imperative, but now there is clear evidence that exclusion and inequality also negatively affect long-term growth capacity. The second challenge has to do with the environmental crisis, climate change, and the need to renew existing infrastructure to avoid an environmental tragedy with a series of socio-economic consequences for all nations. Finally, the most recent but no less urgent challenge relates to the need to create dynamic sources of aggregate demand expansion to promote growth and employment.

And with that, I turn to a reflection on the fundamental role that sustainable infrastructure and national and regional development banks can play in current global economic crisis environment that Latin America is facing.

This is an unprecedented crisis in almost a hundred years. The trade and financial globalization of the last three decades has given the Latin American region a great economic boost. But before the financial crisis of 2008, there was a loss of dynamism in global growth. After the crisis, this loss of dynamism became quite intense for a prolonged period, with consequences not only for the developed world but also for the developing world. The world also went through a change in global economic geopolitics, where “global leaders” such as the United States, Japan, and Germany lost their capacity as sources of growth, while the new ones either do not generate yet the necessary global growth force (China, India), or have simply been into deep crisis – as is the case in Brazil. Global growth therefore is going through a phase characterized by much uncertainty and many dangers.

This puts Latin America in a complex situation, which has been the only region that has enjoyed a significant reduction in inequality and poverty, without having had very high growth rates. The region has addressed inequity with development projects at the national level, but levels of inequality are still morally unacceptable, affecting its ability to grow in the long term. The region’s current economic model requires some fundamental adjustments, related to creating a balance between domestic supply and demand of public and private goods and services, so that it can keep on growing and including.

Different economic formula have been considered for the achievement of more rapid growth. In the face of the crisis and growth slowdown, it has been incredibly innocent that many countries in the region have bet on more reforms to turn the factor markets more flexible, reduce the domestic costs and further open their economies, under the belief that, with these reforms, there will be more access to international trade and more international investment. This is a worrying proposition, because, although some of

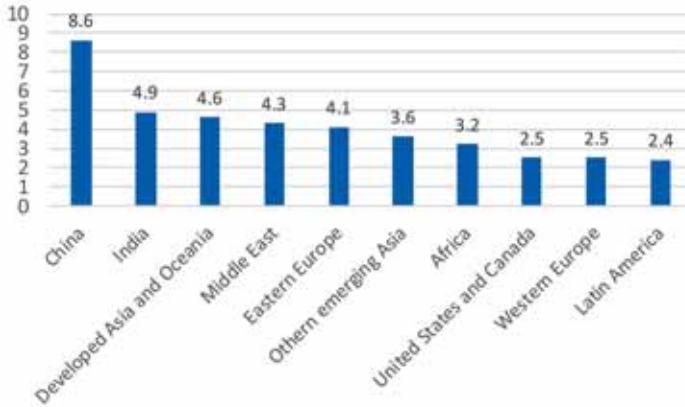
these reforms may be important, they are not enough to achieve their expected results. The global reality is different from those espoused by policy makers: international trade is stagnating, protectionism is a threat, and long-term productive investment flows are on the decline. Therefore, exit through further integration with existing global production and trade networks does not seem possible as a solution for much of the region's economies in the coming decades. The nations of the South have to find an alternative, in which the dynamics of regional growth is driven by national and regional factors. In addition, the challenge imposed by climate change has to be confronted.

To engineer a change in economic model, three types of investments are needed: the first is associated with the expansion and renewal of the productive apparatus, necessary to meet the expanding domestic consumption and to avoid a growth pattern that leads to increasing external vulnerability. The second are those investments necessary to obtain economies of scale that in turn generate both productivity and competitiveness gains – for example, investments in regional physical integration. Now more than at any other time in the last thirty years, Latin America needs a significant expansion of transformational investments that generate growth based on domestic demand that has a positive impact on the productivity and competitiveness of domestic producers. With all the changes in the world economy, the region cannot afford to grow more vulnerable abroad, and therefore it has to promote investments with low impact on imports and on the balance of payments more generally.

The best initiative to tackle simultaneously the three challenges just mentioned is to promote investment in infrastructure, which has been very low in Latin America in the past decade or so. Chart 1 shows that, over 1992-2013, infrastructure investment in the region was at 2.4 per cent, the lowest rate compared with developed regions and countries such as Europe, developed Asia, the United States and Canada, and other developing regions and countries such as Africa, China and India. To scale up infrastructure investment, the national development bank, as an instrument of politics, can help a great deal in this task. A question that one may ask is: Would it not be easier to rely on multilateral banking, and avoid using regional and national institutions? The answer is “no”, because multilateral public banks do not have major advantages over regional and national banks in promoting these investments.

Take the case of the World Bank, where I had the privilege of acting as executive director for seven years. There are three features of infrastructure support in Latin America that draw a lot of attention. In its history, the World Bank has never provided enough financial resources to meet the needs of the region, which are gigantic. Its ability to leverage resources from the private sector is also very limited, which explains a little the very fragile response to the severe crisis of 2009.

**Chart 1**      **Infrastructure investment from 1992 to 2013, as % of GDP – Selected regions and countries**



Source: Studart (2017).

Indeed, the financing of all multilateral development banks for infrastructure investment in developing countries remains relatively low: the annual contribution of all multilateral banks has never exceeded \$140 billion, and may fall to lower levels, very little in the face of infrastructure investment needs in the world. For developing countries alone, a trillion dollars a year is estimated as needed.

Indeed, in the area of infrastructure, the World Bank has concentrated its support on promoting policies for “improving the business climate” – much in the sense of what is known as the Washington Consensus. It has done very little to support the development of local productive capacities, simply because the bidding is basically done with international companies. The regional and national development banks have had a very different form of action. CAF, for example, has played a very important role in the area of infrastructure in the region, while the World Bank has seen its participation decline in this area. In addition, CAF’s role in leveraging private resources has been very important.

In summary, the seriousness of the global crisis has brought to Latin America the challenge of transforming itself so that it can continue to grow with social inclusion and sustainability. The role of national and regional development banks is absolutely critical at this time, in generating training and best practices in the development and implementation of

technical and financially sound projects; and in transforming investments in infrastructure into sources of local productive development, thereby leveraging private resources, which are necessary given the scarcity of public resources in general to meet the scale of investments required for transformation. In order for these institutions to fulfill this role, the first step is to overcome intellectual prejudice against them and to rely more on the region's own capacity to find local solutions to meet our long-term challenges.

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## 8. China's Development Finance Institutions in Context

*Kevin P. Gallagher*

Unlike the Western countries that have been reluctant to increase the capital base of the Multilateral Development Banks, China is increasing the paid in capital for its two global policy banks and has helped capitalize two new multilateral development banks in the New Development Bank (NDB) and the Asian Infrastructure Investment Bank (AIIB). Even before these new institutions get fully operational, China is emerging as the global leader in development finance. In recent years China has helped establish two new multilateral development banks in the AIIB and the NDB. China has also co-established at least 13 regional and bi-lateral funds with a number of countries as well. This short piece provides an overview of these banks and funds.

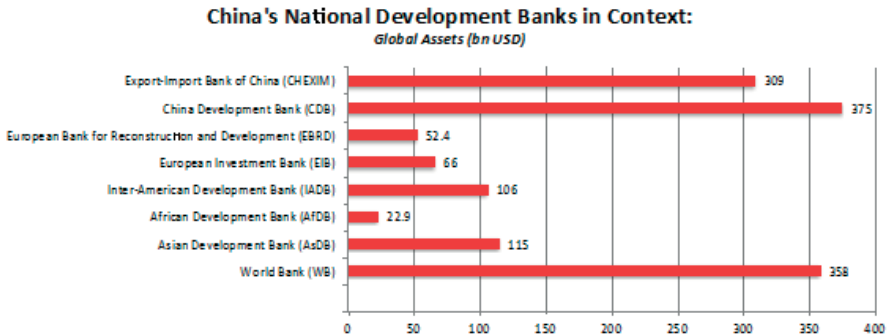
### *China's policy banks go global*

Two of China's policy banks, the China Development Bank (CDB) and the Export-Import Bank of China (CHEXIM) already hold more assets than the combined sum of the assets of the Western-backed multilateral development banks. CHEXIM and the CDB have over \$2 trillion in assets, whereas the Western-backed banks hold just over \$700 billion. That said, CDBs international holdings are just 30 percent of total assets, putting the two banks' international assets at around \$675 billion, giving China's policy banks roughly the same amount of global assets of the major development banks.

These two 'policy banks' as they are called in China, provide non-concessional and concessional (in the case of the CHEXIM) finance in virtually every corner of the world. The CDB holds over \$1.4 billion in assets with roughly \$375 billion overseas—more than the World Bank Group's International Bank for Reconstruction and Development (chart 1). In just over a decade, China has doubled the amount of development finance in the world economy.

During 1994 reforms of the financial sector, the Chinese government created CDB and CHEXIM as "policy banks," whose loans would explicitly support the government's policy objectives (Brautigam, 2009, 79). Prior to 1994, policy lending had been the responsibility of the "Big Four" Chinese banks (Bank of China, China Construction Bank, Agricultural Bank of China and ICBC), so the new policy banks were designed to free the Big Four to act as commercial banks. In separating policy from commercial lending, the government sought to reduce bank managers' moral hazard. If managers could blame all their losses on policy loans, they had an incentive to direct their commercial loans

## Chart 1



Source: Gallagher and Chin (2019)

toward high-risk, high-return projects. The creation of separate policy banks would hold the commercial banks accountable for rational, market-based lending (Walter and Howie, 2012).

CDB and China CHEXIM follow slightly different mandates, which both revolve around strengthening Chinese industry. CDB mainly supports China's macroeconomic policies—laid out in the Five-Year Plans—focusing on eight areas of development: electric power, road construction, railway, petroleum and petrochemical, coal, postal and telecommunications, agriculture and related industries and public infrastructure. An estimated 73.7% of CDB's total new loans went to these sectors (CDB, 2017) In contrast, the China CHEXIM Bank's mandate is to:

facilitate the export and import of Chinese mechanical and electronic products, complete sets of equipment and new- and high-tech products, assist Chinese companies with comparative advantages in their offshore project contracting and outbound investment, and promote international economic cooperation and trade (CHEXIM, 2017)

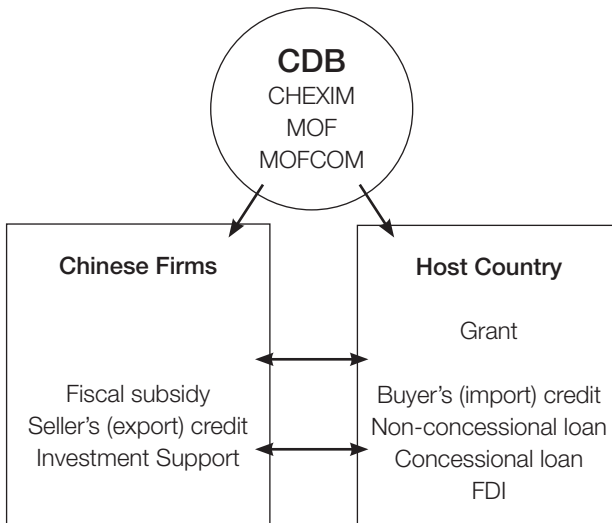
CHEXIM achieves these objectives through the use of export credits, loans to overseas construction and investment projects and concessional loans.

Although the government designed the reforms to divorce policy and commercial lending, Chinese banks continue to mix these lending categories. Steinfeld points out that the government still forces the nominally commercial banks to bail out state-owned

enterprises (Steinfeld, 2000). At the same time, the policy banks have become quite commercial. Former CDB head Chen Yuan married the bank's policy objectives with sound commercial loans so that CDB has high profits and a balance sheet that is even healthier than China's big commercial banks (Downs, 2012). CHEXIM also lends much of its capital at or near commercial rates and boasts a low share of nonperforming loans (Brautigam, 2009; Gallagher and Irwin, 2015).

The structure of Chinese development finance is fairly unique relative to the Western-backed MDBs. We term China's development financing approach the 'consortia approach' and depict that approach in chart 2. The CDB will lead a delegation to a host country and discuss with that country what kind of project that the country seeks finance for—most often some mix of energy, industry and infrastructure. The CDB will provide non-concessional finance to the host country government as individual loans or lines of credit, which can be tied to exports. CHEXIM can often also be at the table, providing the country with concessional finance and buyer's trade credits related to the project. What is more, in some cases the Chinese Ministry of Finance and/or Ministry of Commerce will provide grant support to the host country for the project level as well.

## Chart 2



Source: Gallagher and Chin (2017)



The process does not stop there. The China consortia can also provide support for Chinese commercial entities. The Ministries of Finance and Commerce have prioritized many of China's 'national champion' companies as targeted for global expansion in an effort to globalize China's industrial policy and offers certain forms fiscal support for such efforts. What is more, the CDB offers financing for overseas foreign direct investment and CHEXIM will offer seller's (export) credits. In 2009 the Chinese petroleum giant China National Petroleum Corporation received a \$30 billion line of credit for overseas expansion activities, remarking that "The credit agreement is of great importance for CNPC to speed up its overseas expansion strategy and secure the nation's energy supplies (Nicholson, 2009)". At a signing for a line of credit for the Chinese telecommunications firm Huawei to 'go global,' Chen Yuan, then Chairman of the CDB said "the CDB is more than willing to apply and leverage the experience we've accumulated in our many years of work on development finance.....to help these companies.....become global enterprises, (Sanderson and Forsyth, 2012)". Indeed, according to work by Gallagher and Irwin (2014), between 2002 and 2012 the CDB and CHEXIM provided Chinese firms with more than \$144 billion for their global expansion, with the CDB accounting for more than 64% of the total financing.

In addition to the CDB and CHEXIM, Chinese commercial banks are also often part of the consortia—required by the state to be a component of certain projects. China became Brazil's largest trading partner in 2009, and to further bolster trade and investment in resources and infrastructure, China's commercial banks have been making strategic moves into Brazil's financial sector, positioning themselves more prominently for trade finance and as capital providers in the region. In 2009, Bank of China opened its first branch in Brazil. In May 2015, during Chinese Premier's visit to Brazil, BoC built on top of CDB's announcement that the state policy lender would provide a \$1.5 billion loan to Brazil's energy giant Petrobras, and CDB's promise to lend \$39.5 billion (having already agreed to loans of \$23.7 billion in projects with Petrobras), by noting that, with China surpassing the United States as the world's biggest market for Brazilian products, the bank is "dedicated to provide all kinds of financial services" to Chinese companies in Brazil and to Brazilian firms that want to do more with China (Weihua and Pengfei, 2015).

The Chinese government's "Going Global" policy has brought this amalgamation of commercial and policy lending to the international stage. In 1998, then President Jiang Zemin championed the internationalization of Chinese investment and lending. He argued that "Regions like Africa, the Middle East, Central Asia, and South America with large developing countries [have] very big markets and abundant resources; we should take advantage of the opportunity to get in." (Yuan, 2009) As Downs (2011) points

out, CDB is the main bank supporting this strategy with loans to Chinese and foreign companies overseas. Bräutigam adds that “the Eximbank has been at the center of China’s strategy of ‘going global.’” (Brautigam, 2009, 112).

### *China-backed development funds*

China has also pioneered a host of bilateral and regional development funds. These funds combine to add upwards of \$178 billion in development finance provided by the Chinese in recent years and are exhibited in table 1.

A major portion of these investments are in Asia as part of China’s broader “Belt Road Initiative, with the largest being the \$54 billion Silk Road Fund established in 2014 with investment from state institutions including the CHEXIM and CDB and replenished in May of 2017. The fund is open to investors from other countries as well and has provisions to expand maritime connectivity between China and the rest of Asia (Central, South and Southeast Asia, the Middle East), North and Northeast Africa, and Europe. A related fund is the Green Ecological Silk Road Investment Fund, a private equity fund for improving the ecological environment in the region.

In the larger Eurasian region, investments include the China-Central and Eastern European (China-CEE) Fund— set up to facilitate financing of projects to enhance inter-connectivity in the region, specifically in Eastern Europe— and the bilateral Russia-China Investment Fund (RCIF) established by two government-backed investment vehicles, the Russian Direct Investment Fund and China Investment Corporation (CIC). The RCIF will invest 70% of its capital in Russia and other CIS countries (currently Azerbaijan, Armenia, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Uzbekistan and Ukraine) and 30% in China.

Over the last decade China has created a significant platform of public and private investments in Africa. To date the largest of such initiatives is the China-Africa Industrial Capacity Cooperation Fund Company Limited (CAICCF), jointly established by the China Foreign Exchange Reserves and Export-Import Bank of China. With \$10 billion in pledges, the fund would support infrastructure development, particularly in the transit sector, as well as provide financing for manufacturing and agriculture projects. Among the state-backed funds is the China-Africa Development Fund (CAD Fund), a Chinese private equity fund financed by the CDB, set up in order to stimulate investment in Africa by Chinese companies in power generation, transportation infrastructure, natural resources, and manufacturing. This fund has \$10 billion in pledges and has disbursed upwards of \$2billion. The Africa Growing Together Fund (AGTF), is a fund inside the African Development Bank financed by the People’s Bank of China, is to finance eligible sovereign and non-sovereign guaranteed development projects in Africa.

**Table 1**

<b>Chinese Development Funds in the World Economy</b>	
	<b>\$USB</b>
<b><u>Asia</u></b>	
Silk Road Fund	54
The Green Silk Road Fund	4.8
China-ASEAN Fund (with ADB)	1
<b><u>Eurasia</u></b>	
China-Central and Eastern Europe Investment Fund	4
Russia-China Investment Fund	2
China-Russia Regional Cooperation Development Investment Fund	14
Russia Direct Investment Fund	10
China-VEB Innovation Fund	1
The China-Kazakhstan Production Capacity Cooperation Fund	2
<b><u>Latin America and Caribbean</u></b>	
CELAC-China Investment Fund	20
China-LAC Industrial Cooperation Fund	10
China-LAC Investment Fund (with IADB)	5
China-Mexico Investment Fund	2.4
China-Portuguese Speaking Countries Cooperation Fund	1
China-Brazil Investment Fund	20
<b><u>Africa</u></b>	
China-Africa Development Fund	10
Africa Growing Together Fund (with AfD)	2
China-Africa Production Capacity/Industrial Cooperation Fund	10
<b><u>Global South</u></b>	
South-South Climate Fund	3.2
South-South Cooperation Fund	2
<b><u>Total</u></b>	<b>178.4</b>

Source: Gallagher and Chin, 2019

In the larger arena China seeks to strengthen South-South relations and contribute to global development. To this end, China announced the creation of the \$3.1 billion South-South Climate Cooperation Fund in a China-United States joint presidential statement on climate change in September 2015, to be used to finance initiatives in developing countries worldwide to combat climate change. China also pledged \$2 billion in the creation of a South-South Cooperation Fund aimed to assist developing countries in implementing their post-2015 development agenda, as announced last year at the United Nations Sustainable Development Summit at the UN headquarters in New York. Plans to create an Academy of South-South Cooperation and Development was also announced, with the aim to facilitate studies and exchanges by developing countries on theories and practices of development suited to their respective national conditions.

Chinese finance also plays a prominent role in the Latin America and the Caribbean—with \$58.4 billion in funds in the region. The largest are the \$20 billion CELAC-China Investment Fund for infrastructure projects, the China-Brazil Investment Fund, and the \$10 billion dollar China-LAC Industrial Cooperation Fund for medium- and long-term financing for industrial investments. Investments in the region further include the China-LAC Cooperation Fund, initiated by the Chinese Government to finance projects in LAC region in areas including education, water conservancy, and energy. The Fund is housed at the Inter-American Development Bank and includes a private equity (PE) fund administered by the Export-Import Bank of China. In addition to these, the China-Mexico Investment Fund was set up to support Chinese and Mexican companies investing in infrastructure, mining, and energy projects in both countries.

### *New Multilaterals*

In addition to making stepwise contributions in paid in capital to its two global policy banks, China recently helped found two global development banks, the NDB and the AIIB. The NDB was launched in July 2015 by Brazil, Russia, India, China and South Africa - collectively known as BRICS countries. The NDB provides financing to developing countries to help finance sustainable infrastructure projects, releasing its first set of financing packages for clean energy and largely financed from green bond issuances in the Chinese market, in the spring of 2016.

The Asian Infrastructure Investment Bank (AIIB) was created to support infrastructure construction in the Asia-Pacific region. The AIIB was proposed by China in 2013 and formally started operations in December 2015 after the Articles of Agreement (AoA) entered into force with ratification from 17 member states holding 50.1 per cent of the

shares. This is in accordance with the AoA that requires ratification from 10 member states holding a total number of 50 per cent of the initial subscriptions of the authorized capital stock. By July of 2017 the AIIB had 80 members and prospective members, including six from Latin America in Argentina, Bolivia, Brazil, Chile, Peru and Venezuela. The Memorandum of Understanding (MoU) specifies that the authorized capital of AIIB is \$100 billion and the initial subscribed capital is expected to be around \$50 billion . AIIB's investment capacity could reach \$250 billion by the end of 2020 in accordance with provisions made in its AoA. The Bank will largely co-finance projects with the World Bank (WB) and Asian Development Bank (AsDB), particularly in the first years of its operations.

### *China and the MDBs*

China now has a stake in all the major MDBs, including the World Bank (WB), Asian Development Bank (ADB), African Development Bank (AfDB), Inter-American Development Bank (IADB), the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB). As shown in Table 2, the Chinese have contributed \$22.92 billion to these institutions. China's largest contribution is to the ADB, at \$11.32 billion , followed by a \$10.94 billion contribution to the WB. China's capital in the IADB is the smallest, at \$3.74 million.

**Table 2** China's share in existing MDBs

	<u>Total capital</u>	<u>China's capital contribution</u> (USD billion)	<u>Capital share* (%)</u>	<u>Voting share** (%)</u>
<b>WB (IBRD)</b>	223.2	10.94	4.9	4.42
<b>ADB</b>	175	11.32	6.47	5.47
<b>AfDB</b>	32	0.66	2.05	1.13
<b>IADB</b>	170	0.0037	0.0022	0.0038

\* Capital share refers to the percentage of a member's subscription to shares of the capital stock.

\*\* Voting share consists of the sum of a member's basic votes and proportional votes as a percentage of total.

Source: Gallagher and Chin, 2019

China's capital contributions, and thus its voting share in these institutions, are still relatively small. At the World Bank, despite being the second largest economy in the world China has the 3<sup>rd</sup> in IBRD rank in terms of voting shares and the 3<sup>rd</sup> at the ADB, at 4.42 and 5.57% respectively. Conversely, the United States enjoys much larger voting shares in these institutions. Indeed, the United States holds 15.02% of the vote at the WB and 12.75% of the vote (behind Japan) at the ADB.

## Conclusion

This short note has surveyed the incredible expansion of Chinese development finance in the world economy. In a very short period, China has become the leader in global development finance in material terms. Not only has China become a shareholding and active member in all of the major MDBs in the world economy, it has also created a suite of other development finance institutions that have almost doubled the amount of global development finance available.

The challenge for China will be to maximize the benefits of this overseas financing while mitigating the risks for China and host countries alike. Where China has great promise in this regard is the fact that China tends to finance large infrastructure and industrial projects that are more conducive to long run transformation and growth than the composition of financing on offer from the MDBs. What is more, the Chinese development finance institutions also do not require policy conditionality to be attached to their loans, which builds better trust and leads to better outcomes.

However, large infrastructure and industrial projects are not without risks. China and host countries alike will need to put in place necessary risk assessment and mitigation techniques to safeguard for debt sustainability, social and environmental risk, and social inclusion. If China can do that, it is poised to lead the world in global development finance.

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## 9. Development Bank of Latin America - CAF

*Luis Calle*

I discuss in this piece the role of the Development Bank of Latin America (CAF) in supporting development finance in Latin American region, and in particular, the efforts the bank is making to bring resources to the region to implement sustainable projects, and the different projects it is currently planning to carry out in the region.

CAF is a supranational financial institution that belongs to the countries of Latin America. The bank already has 45 years of financing economic and sustainable development, and regional integration in Latin America. It is a leading development bank in the financing of infrastructure and energy projects in the region. It also has the status of preferred creditor, which is basically what gives it the guarantee of a smooth operation. Shareholder countries of the bank have always honored the debts they have and this support is what has allowed it to grow constantly. The bank also takes a good care of its financial statements, given the demands of the rating agencies, and this has allowed it to have very high rating levels. At the time of writing the bank is AA with the main rating agencies.

CAF has undergone major changes since its creation in the year 1970. Initially, it was purely an organization of the Andean countries. Fast moving to the year 2016, the bank then had already 19 shareholders (17 Latin American and Caribbean countries in addition to Spain and Portugal). The other important feature is that the bank does not have donor countries. The only extra-regional countries are Spain and Portugal, which makes CAF an Ibero-American institution.

The fact that the bank's shareholders are mainly Latin American countries, which are developing countries (or emerging countries), implied it had the duty to manage its resources in the most productive and appropriate way.

Currently, the bank has a presence in practically all Latin America. The bank's headquarters are in Caracas, but it also has offices in virtually all the region, so that it is closer to its clients and is able to give them the best possible support. In addition, the bank has two regional hubs: one in Panama, which supports most of the operations in the northern part of Latin America; and another in Montevideo, Uruguay. The bank also has a regional office in Madrid, which looks after all the relationships with European and Asian agencies. In total CAF has 13 offices.

In the balance sheet information as of September 2016, the main indicators are the bank's total assets of \$35 billion, a net worth of \$10 billion and a loan portfolio of \$22 billion.

The financial liabilities are around \$24.5 billion; the latter mostly correspond to international bond issues that it carries out in virtually all international markets. The loan portfolio is completely diversified among shareholder countries in the region.

Another important feature is that CAF serves both the public and the private sectors. The public sector accounts for a large part of the total loan portfolio – 80%, while the private sector accounts for the remaining 20%. In the public sector, CAF funds large projects in the region. And, as just mentioned, it supports the private sector as well, including the small and medium-sized enterprises. Recently, CAF's private sector strategic approach was reformulated to target four key sectors, through supporting: 1) small and medium enterprises in the region through microfinance; 2) the development of renewable energies; 3) the development of sustainable transport; and 4) *agrobusiness*, where Latin America has much potential; that is a sector in which the bank is starting to try to generate new operations.

The loan portfolio by economic sector is basically focused on two sectors that represent 60% of the total portfolio. The first is the transportation sector, which includes roads, mass transit systems that are sustainable and help mitigate the effects of climate change, and also ports and logistics. The second sector is energy, specifically renewable energy (hydropower, wind, photovoltaic and energy efficiency), which is critical for what it means in terms of sustainable development in the region. The bank also supports social development (water and sewerage, health and education) and what has to do with regional financial banking.

Regarding the amount of approvals in the region, these are around \$12 billion. To give an idea of how much progress this means, in the 1990s, CAF barely approved \$400 to \$500 million per year. However, although significant, the current loan amount is not enough. Thus, CAF needs support of more international agencies, and regional ones as well, for all the region's needs. In this regard, CAF is collaborating with those agencies that have interest in the region to be able to implement all the projects that it has in Latin America.

In terms of support and financial mechanisms with partners, I first start by the bank's mission on sustainable development, regional integration and mobilization of resources. These three elements are very important, particularly in my department, which is the Department of Institutional Financial Resources. The department is in charge of resource mobilization through international agencies for the different projects in the region. The department's objectives are very aligned with CAF's mission, which is to support the co-financing of loans and projects, optimize the use of sources of funds and the cost of fundraising, and maintain the best relations with

the international financial community, in order to be able to diversify the sources of financing to obtain quality resources and technical assistance.

In that sense, the focus is on two main areas: financing and co-financing products. In the financing products area, the department basically has concessional credit lines. I mentioned that CAF's shareholder countries are developing countries and the bank does not have donor countries, so the department has to make extra efforts to obtain softer resources in order to make projects in the region viable. The bank through the department of financial resources has also developed local currency programs, specifically for SMEs, through loans in local currency to microfinance institutions, so that they can on-lend to small and medium-sized enterprises. The bank also has technical cooperation programs drawing on its own resources, which are nonetheless limited due to the fact that it does not have donor countries, as just mentioned. These are resources that come from the annual profits granted by CAF, and that also creates the additional challenge of obtaining assistance resources with other international institutions.

Finally, the bank has the co-financing area: A/B loans (a co-financing arrangement with other institutions), loans co-financing with international agencies and even the purchase and sale of the portfolio. Once the bank has already granted loans, it looks for agencies that have an interest in investing in the region and with that it attracts additional resources to the region.

What kind of cooperation does CAF have with its partners? I highlight here four areas: first, concessional credit facilities. Second, technical assistance resources, some of which are obtained with the European Union and which are vital for the development of many of the projects the bank is implementing in the region; third, transfer of knowledge; in September 2016, for example, CAF signed a cooperation agreement with the BRICS New Development Bank. They have already been asking CAF about its system of governance, its workings and its administrative part, because it has been a successful model during its 45 years of operation, and the bank gladly exchanges that information. And thanks to that, the bank has signed a cooperation agreement to exchange knowledge and even to support seminars. Fourth, creation of funds, which basically is about funds that have green content. For example: the geothermal fund, which is a fund that the bank has been working with KfW. Geothermal is a renewable energy that practically does not exist in South America; in Central America there are ongoing projects, but in South America there is none. And, with KfW, CAF is structuring a fund of about 50 million euros, which it expects to reach 100-150 million euros to support green projects in the region.

I would also like to mention that the bank has recently signed an accreditation agreement with the Global Environmental Fund: it is the first institution in the region that will be able to submit projects to the Global Environmental Fund for approval, with the consequent benefit of the good terms and conditions that they offer.

The benefits of these cooperation initiatives and, in particular, obtaining concessional facilities are, obviously, the cheaper financial conditions than CAF could otherwise obtain through its own issuance in the international markets, but also the longer-term maturity – fifteen years, even. The bank is currently exploring with the Republic of Korea maturity of twenty to thirty years, including large grace periods and concessional interest rates for projects to be developed. These kinds of credit lines allow CAF to transfer the benefits of cheap cost to the region's projects, thereby making them viable. It also allows the bank to transfer knowledge relating to best international practices that it has with the best international agencies.

CAF is working on co-financing with agencies that do not have a large presence in the region. The bank has the technical capacity and good knowledge of the region, while they have the best practices to do the studies. There is therefore a combination of strengths that allow the bank to structure projects optimally. Examples involve energy projects with the KfW and a road project in Bolivia. The fact is that CAF works with all the partners in different sectors.

With some other agencies, CAF has sources of technical assistance. An example that is very relevant at the moment for the region is a facility that the European Union has that allows CAF to obtain technical assistance resources to support different projects. Basically, these technical assistance resources allow for subsidies, ie: lowering fees in the projects the bank is funding, and technical assistance for the study of projects. A good example is a very interesting project study that was done in Bolivia: a study of electrical interconnections in the subject of integration and interconnections.

Finally, I wish to mention the efforts CAF is making in the area of knowledge transfer; I would like to mention in particular two initiatives that the bank is implementing. One is the coordination role the bank has regarding the International Development Financial Group, which is a club of 24 regional institutions from all over the world, in which institutions exchange best practices. Jointly, the group developed studies that present the different impacts of the projects in the region. The other is CAF's collaboration with Singapore International Enterprise, which is the agency that promotes imports in Singapore. CAF has done trainings with the senior executives of the different governments of the region, so that they will know – in Singapore,

in a week – the different experiences and good practices that have been done in this country. This year, an effort was made in infrastructure (ports, transport, metros, highways), a sector in which Singapore is very strong. It also includes all the technological systems they have implemented there, so that they can bring and apply all that knowledge to the Latin American region.

## 10. The Brics New Development Bank (NDB)

*Marcelo de Lima*

In this article, I provide some basic information about the BRICS New Development Bank and then the bank's projects and the current cooperation agreements at the bank level. I do so in my capacity of an official of the Ministry of Finance in Brazil. I will also mention the bank's context, its institutional structure, nature, strategy (including the axes of action), prospects for new members, regional integration, projects and cooperation with other institutions, especially regional and multilateral development banks.

The international treaty that created the New Development Bank was signed during the Sixth BRICS Summit in Fortaleza in 2014. The finance ministers are the governors of the Governing Board of the Bank, the highest collegiate body of the institution.

The Bank's objective is to mobilize resources for infrastructure and sustainable development projects in BRICS countries and other developing countries, in addition to the existing efforts of multilateral and regional financial institutions for global growth and development. Please note that infrastructure and sustainable development are inseparable. In that way, it would not be possible in principle to have a project without either of these two aspects. To meet its objective, the Bank's aim is to support public and private projects through loans, guarantees, equity participation and other financial instruments. It shall also cooperate with international organizations and other financial institutions, in addition to providing technical assistance for projects approved by the Bank.

New member countries will have to negotiate the level of their participation. Each founding member has initially subscribed 100,000 shares, totaling US\$ 10 billion, of which 20,000 shares constitute the paid-in capital, totaling US\$ 2 billion, and 80,000 shares constitute the required capital, in a total of US\$ 8 billion. There is a payment schedule for subscribed capital, to which the founding members are committed (see table 1). In terms of its structure, the Bank is composed of two collegiate bodies: the Board of Governors, mentioned above, which is the collegiate body of finance ministers, and the Board of Directors. Up to the present time, each BRICS country holds precisely 20 per cent of the capital. Most administrative decisions are made by the Board of Directors. There are still no executive directors to represent a group of countries (constituencies), but one director per country.

It should not be forgotten that the Bank is a recent institution that began its administrative activities in 2015. The first group of projects was approved in April 2016. In total, seven project loans were approved in that year: two in China, two in India, and Brazil, Russia

**Table 1 The payment of the initial subscriptions of disbursed capital, by each country BRICS.**

SHARE	Capital disbursed per country, in millions of dollars
1	150
2	250
3	300
4	300
5	300
6	350
7	350

and South Africa had each one project loan approved. Of the seven projects, six were in renewable energy, including projects in solar, wind, and green energy transmission. Three projects were sovereign, two sovereign guaranteed and two non-sovereign, with a total loan amount reaching \$1.6 billion (NDB, 2017). These loan approvals were the result of the following proposal submissions:

- a. **Brazil:** proposal for a \$300 million loan, without sovereign guarantee, made by the National Bank for Economic and Social Development (BNDES) as financial intermediary for the financing of renewable energy projects and related transmission;
- b. **South Africa:** financing proposal for Eskom Holdings Company Limited's \$180 million project for the integration of independent renewable energy producers (RE-IPP) and increased transmission capacity to promote the development of the Soweto region;
- c. **China:** the first proposal was for a loan of RMB 525 million made by Shanghai Lingang Hongbo New Energy Development Co. Ltd., for the Lingang Distributed Solar Energy Project. The second proposal was for a RMB 2 billion loan for the Pingtian Bay Offshore Wind Energy Project;
- d. **India:** the first proposal was for a \$250 million sovereign guaranteed loan made by Canara Bank for the Renewable Energy Financing System. The second proposal was for a \$350 million loan to the Government of India for the Main District Road Project of Madhya Pradesh;
- e. **Russia:** loan proposal for \$100 million through the multilateral banks (Eurasian and International of Investments), linked to the 49.8 megawatt hydroelectric project in Russia of JSC Nord-Hydro-Bely Porog.

The Bank is defining its identity and learning the specific needs of its members and other developing countries. This is a good time to exchange information between

the institution and the countries, because there is still a lot of flexibility in the Bank's governance. The Bank's emphasis is on the quality of each project, in line with the policies already approved.

Management and directors are discussing the Bank's strategy for the coming years. The main lines of action will probably include:

- a. renewable energies, energy efficiency (including efficient buildings), sustainable waste management, clean transport, sustainable water management, wastewater treatment;
- b. projects in which there is interest of more than one country, especially infrastructure that facilitates trade; and
- c. transformative projects to promote regional integration and connectivity.

The Bank's first regional office is located in South Africa, and the second is planned to be in Brazil (The Economic Times, 2018). Other offices will be established in Russia and India, in alignment with NDB's general strategy. Directors are also considering the admission of new member countries but will always retain at least 55 per cent of the bank's voting power.

In order to promote transparency and accountability, the Bank has published many of its main policies. These documents are available on the institution's website (*available at* <https://www.ndb.int/data-and-documents/ndb-core-documents/> July 11, 2018). The policies published are as follows:

- *Board of Directors Governance Structure;*
- *Code of Business Conduct and Ethics;*
- *Code of Conduct for Board Officials;*
- *Environment and Social Framework;*
- *Country Partnership Plan;*
- *Information Technology Policy;*
- *Information Disclosure Policy;*
- *Policy on Financial Management and Financial Analysis, and Economic Analysis of Projects;*
- *Policy on Loans with Sovereign Guarantee;*
- *Policy on Loans without Sovereign Guarantee to National Financial Intermediaries;*
- *Policy on Partnerships with National Development Banks;*



- *Policy on Transactions without Sovereign Guarantee;*
- *Procurement Policy;*
- *Tecnical Assistance Policy;*
- *Amended Rules of Procedures of Board of Directors of the New Development Bank;*
- *Amended Rules of Procedures of Board of Governors of the New Development Bank.*

The first NDB bond issue occurred in 2016 in the Chinese interbank market: green bonds totaling RMB 3 billion. According to information provided by the Bank, 80% of this value should be converted into dollars (US\$). The purpose is to provide resources for environmental projects in member countries.

Directors are still thinking about the level of technical assistance that the Bank will be able to offer to each country, since the NDB structure is simple. Therefore, it is advisable that the project has the potential to be bankable and that it already has minimum technical data prior to submission to the Bank. It is necessary to remember that the Bank works on a project-by-project basis.

There is much scope for cooperation with other international development banks. Indeed, cooperation agreements are an essential part of the work of the New Development Bank. They may have different legal forms: protocols of intent, memoranda of understanding, terms of reference, legally binding agreements, etc. In exercising the prerogative of negotiations with other international organizations, the bank must consult the governors of each member country and obtain permission to act in order to comply with the provisions of its constituent agreement and to ensure that the internal governance is exercised appropriately.

Memoranda of understanding have been already signed with the Andean Development Cooperation (CAF), the Asian Development Bank (ADB) and the World Bank Group (WBG). These memoranda have as objectives or activities to:

- a. explore and seek opportunities for co-financing projects;
- b. facilitate the exchange of knowledge regarding their respective operations, in accordance with their policies and procedures;
- c. explore and seek opportunities for advisory services in priority areas identified by the NDB;
- d. facilitate the training of human resources, including secondments and exchange of personnel;

- e. explore and look for opportunities in treasury management cooperation;
- f. provide training in priority areas identified by the NDB;
- g. providing technical assistance at the country level;
- h. encourage other types of cooperation, according to the intention of the institutions concerned.

Finally, it is essential to say that other similar instruments are being negotiated between the NDB and international financial institutions. The Bank is open to new possibilities for cooperation and wants to integrate a broad and development-friendly network.

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## 11. The Inter-American Development Bank

*Javier Díaz Cassou*

The IADB is a multilateral development bank that has been operating for decades. Thus, in a sense, it can be said that it represents the status quo. Yet, given the bank's long track record, the process of building a new, solid financial architecture in Latin America can and should draw extensively on the positive experiences it has accumulated over the years. In other words, it is important to also consider what exists and the best way to take advantage of it. The IADB is an instrument that is really contributing a lot to the region, and it would be a shame to forget in this whole process of reform what it does.

This article is about the bank's support framework for regional projects. Why does the Bank prioritize integration? The first reason is because the IADB itself is a large regional project – it is first and foremost a regional, Latin American institution. Therefore, its natural tendency is to promote initiatives that contribute to the integration of the region. The bank also believes that integration is key to overcoming some size disadvantages in some of the region's economies. In Latin America, there are many countries that are very small, and without integration they will have significant obstacles to attracting foreign investment, increase competitive gains, gain access to global markets and have the leverage they need in global forums.

The Bank has a Sectoral Strategy to Support Regional and Global Competitive Integration<sup>1</sup>. The main points I would like to mention are the fact that in the ninth capital increase approved by the member states a few years ago, they set a very specific goal: that at least 15% of the loan and operations portfolio has a regional scope – that is, that involves more than one country, which has some components of integration. These implies projects that go from financing roads to connect two countries to electrical interconnection projects or border crossings. There are many types of projects that can be considered supporting regional integration. But what is relevant here is that the bank is required to have 15% of the road in a project contributing in some way to integration. This is a goal the bank has met and even exceeded, so that today more than 15% of its portfolio of projects are in one way or another promoting integration.

The merit of this achievement is that it is important to bear in mind that for an international financial institution such as the IADB, regional integration projects are particularly complex because they have more executors with whom to coordinate. When the bank

<sup>1</sup> <http://www.iadb.org/es/temas/integracion-regional/estrategia-de-integracion-competitiva-mundial-y-regional,2802.html>

works with a single country, the number of executors usually is a single one; when it works with two countries, much better coordination is required, which sometimes slows down execution and discourages Bank officials as well as governments themselves from embarking on projects with an integration component.

One of the pillars of the Bank's vision on integration is that it is fundamental to coordinate efforts in hardware – that is, physical infrastructure, and in software – that is, everything that has to do with regulations, institutional capacity, etc. The reason is clear: *it is useless to have the best of roads and the best of border crossings, if we do not have some kind of regulatory harmonization between what happens on both sides of the border. In the end, if we do not combine efforts in these two areas, the risk is to end up having an infrastructure that does not serve to achieve the objectives that are raised.*

Another among the pillars of IADB integration strategy is supporting the generation of regional public goods. Examples are environmental and health issues; indeed, there is a multitude of issues for which regional public goods need to be provided, and UNASUR is one of the examples of the institutions that are really contributing a great deal in this regard.

The main pillars of IADB integration strategy are therefore the hardware part, the software part and the regional public goods part. The strategy involves projects that, to the extent they imply coordination involving two countries, they become more complex, more costly and more difficult to execute. For this reason, it is worth mentioning a recent bank's initiative that aims to generate the appropriate incentives to mobilize more resources towards projects with a development component. The IADB should be understood as a credit cooperative in which the borrowing countries have a credit quota that is defined annually according to the needs of the country and the creditworthiness of the cooperative as a whole. What the bank has done is that 10 per cent of that total volume of resources is not initially allocated to the countries, but, rather, serves to finance integration projects that do not consume quota. In this way, an incentive is generated to obtain more loan credit resources from the bank, which in a way allows for compensating for the additional complications that the integration projects have for the reasons just mentioned.

### *Typology of integration projects*

Here I offer a typology of integration projects on which the bank has been working. It is important to keep in mind that these initiatives range from foreign trade windows to roads, electrical interconnection, among many others. A key message is that, to support these initiatives, the bank does not only use loans: it also invests a lot in

knowledge, and there is a very strong research agenda with the theme of integration. For example, the bank has developed databases that can examine aspects ranging from the diversification of exports from all countries to the state of all regional agreements that exist in the region.

There is a type of instrument on which IADB also has a lot of influence, which is the policy dialogue. The bank fosters meetings of senior officials who contribute to the ongoing initiatives that exist in the region to generate concrete results. For example, bank staff regularly meets finance ministers from the region to discuss issues of integration and many others of regional interest. The bank has technical cooperation programs that it calls South-South, which consist of financing visits of national officials to some institution of another country of the region, which has been particularly successful in any particular initiative. To do this, the bank makes contact between institutions and finance the trip because it seems to the bank that, in Latin America, there are not enough mechanisms to learn from the successful experiences that occur in the region itself, and sometimes there is a tendency to look outside the region to seek lessons learned.

#### *The South American Council for Infrastructure and Planning (COSIPLAN)*

Still on regional integration, it is important to review the role that the bank has played in financing the infrastructure projects of COSIPLAN, a council created to support infrastructure integration in South America. The bank has actively participated in the financing of 35 projects in 10 of the 12 UNASUR countries. In total, it has mobilized \$4.6 billion in projects totaling \$12 billion. And it has financed roads, ports, generation and electricity interconnection, border crossings, among others.

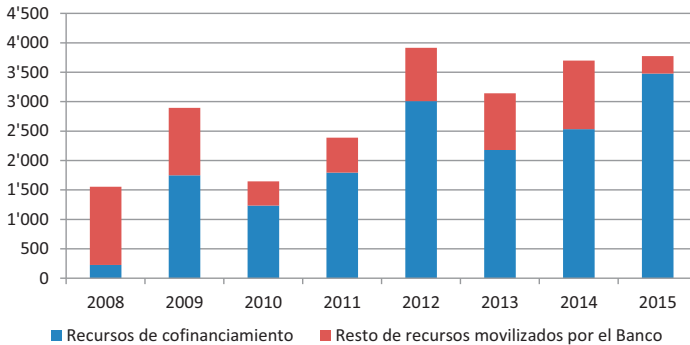
Another initiative of regional scope, in which IADB has participated on an important scale, is the project Mesoamerica, in which the bank has acted not only as provider of technical assistance and multi-sectorial support for project implementation, but also as financiers: 38 projects involving \$1.7 billion in loans to electricity interconnection, transport, telecommunications, trade facilitation, etc.

#### *The growing role of co-financing*

To support its various project loans and operations, including those relating to integration, IADB has increasingly relied on resources from co-financing. It has also increased strongly the number of partners over time and taken advantage of its extensive membership to partner with institutions from countries from regions other than Latin America.

Chart 1 shows the composition of the amount of resources mobilized by the Inter-American Development Bank in recent years: the blue part shows the co-financing resources and the red part the IDB's own resources.

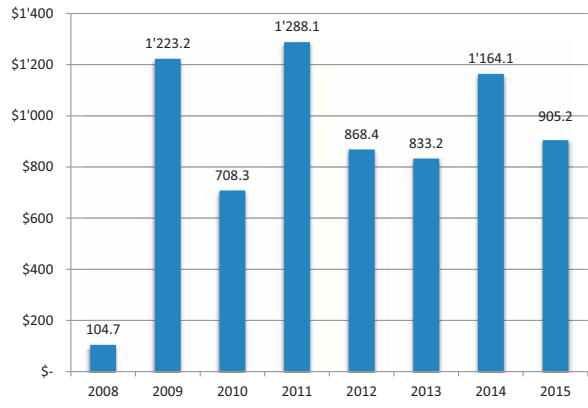
**Chart 1** Co-financing versus Other Resources Mobilized by the IADB  
(\$ Million)



Source: Author's estimation, IADB.

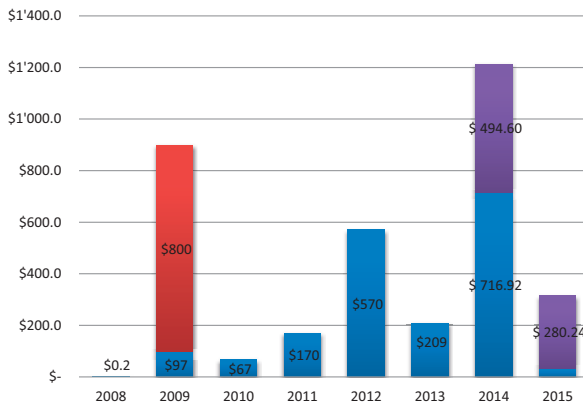
What we can see is that co-financing is playing an increasingly important role for the bank: between 2008 and 2015 it mobilized \$16.2 billion in co-financing for the region, in a total of 192 transactions. While, in 2008, the bank had 42 partners in co-financing, in 2015 it had 389 partners. It is, therefore, an area in which the bank is working very actively, for which it surely helps to have extra-regional members. This is shown in Chart 2: on the right side are the amounts of co-financing that IADB mobilizes with European institutions and which are still the most relevant: \$1 billion a year. Chart 3 shows the growing role of co-financing with Asian institutions.

**Chart 2 Resources mobilized with European institutions (\$ Million)**



Source: Author's estimation, IADB.

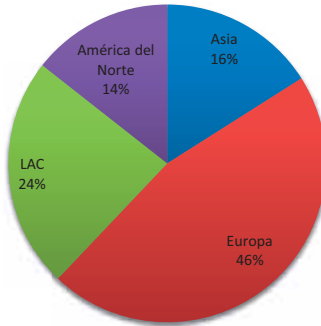
**Chart 3 Resources Mobilized with Asian Organizations (\$ Million)**



Source: Author's estimation, IADB.

Chart 4 shows the geographical composition of co-financing: almost half comes from Europe, 24 per cent from the region itself, 14 per cent from North America and 16 per cent (and growing) from Asia.

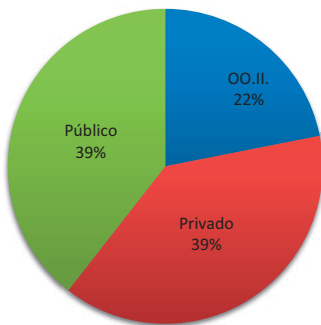
**Chart 4 Geographic composition (2008-2015)**



Source: Author's estimation, IADB.

Finally, Chart 5 shows co-financing by type of organization: international organizations account for about 22 per cent of the total, the private sector 39 per cent and the public sector another 39 per cent.

**Chart 5 Transactions by Type of Organization (Average 2008-2015)**



Source: Author's estimation, IADB.



## 12. Boosting resilience and growth – the case of the Islamic Development Bank

*Walid Abdelwahab*<sup>1</sup>

The role of multilateral development banks is changing, reflecting a new development paradigm that is much more ambitious than in the past. In part, this reflects the shift from a narrow poverty-focused agenda (the UN-led Millennium Development Goals of 2000-2015) to a wider Sustainability-focused agenda (led by countries, the 2015-2030 Sustainable Development Goals). At the same time, countries are evolving, their needs are changing, and need to respond to new external shocks.

Developing countries, and especially the middle-income ones, are demanding more and different things from development banks than they did in the past. In particular, they demand more than just finance – they also demand that multilateral development banks should be catalysts, facilitators, conveners, and mobilisers of funds, especially private capital. They are also demanding stronger role in running MDBs, wanting more voice and representation, and a role in governance. This is reflected in the creation of new, regional MDBs with a larger shareholding by the South. There is also a growing resistance to globalization – due to its consequences in terms of rising inequality, job losses, migration, environmental degradation, financial volatility. These trends are reflected in policies relating to Brexit, and the election of United States President Donald Trump and his protectionism agenda.

Given this context, MDBs have a new role. Countries say that MDBs need to adapt and respond to country demands, rather than being focused on a selected, smaller number of sectors based on corporate strategies. At the same time of increasing demands and expectations, MDBs are also increasingly constrained in terms of their resources – overstretched for what they need to do, especially as major shareholders are not in favour of new capital injections. Hence, MDBs face a scenario where they must do more with less.

As part of this new role, another trend is that countries want MDBs to focus more on the local and regional dimensions of development – making better use of domestic savings

<sup>1</sup> This brief note is based on a series of presentations given by Dr Abdelwahab from 2016-2017 held at Boston University, United States; UNASUR, Ecuador and SAIIA, Johannesburg. Following the delivery of these presentations, the IsDB has announced a major restructuring on 1 January 2018 based on a decentralized delivery model, moving and empowering a large portion of its staff to the field and adopting a proactive and private sector led development model dubbed “Making Markets Work for Development”.

and natural resources; boosting the development of local and regional capital markets; and combatting illicit financial flows and tax havens.

Another change in their perceived role is that MDB performance will soon be measured by their leveraging power, rather than their financing power. This comes about because there is increasing reliance on the private sector to cover funding gaps.

Against this backdrop of expectations of a new role for MDBs, the banks also face several important dilemmas. These include selectivity versus diversity, and the persistent inequality within and between countries. There are “two faces” of developing countries vis-à-vis the world. On the one hand, globally the number of people living below the poverty line dropped below 10%. However, on the other, the number of poor people in Africa increased by nearly 200 million and inequality is increasing in many parts of the world.

In the past, MDBs had deliberately focused on specific sectors and themes, which meant, for example, neglecting infrastructure while focusing on ‘poverty programmes’. This led to “Decades of Neglect” that are only now being addressed. To this end, today MDBs are choosing to work more together – for example, the long-standing regional development bank ADB announced co-financing targets of 100% by 2020 compared to 80 per cent in 2016 and 4% in 1976. Similarly, the IsDB co-financing target is 170% by 2020, against its current level of 100%. The new regional development banks also have co-operation and co-financing as part of their vision – for example the president of the Asian Infrastructure Investment Bank, Li-qun Jin recently said “AIIB would focus on infrastructure investment and stay away from concessional operations, social sector, policy-based lending, and research work. AIIB would aim at being a leaner institution without a resident Board. Because of these characteristics, there would be more scope to cooperate and complement each other”.

Reflecting these new dynamics and paradigms, the changing role of MDBs is contributing to a new footprint for development banking, whereby banks are moving away from a global footprint based on primarily northern shareholding, to a more regional footprint and more southern-based shareholding.

Real issues still to be addressed include the problem of illicit financial flows from developing countries. Of 34 OECD countries, 27 meet only partial requirements for reporting and addressing illicit flows, and no OECD country is currently fully compliant. This is a major problem that needs to be addressed.

One reason for this is that financing the SDGs, climate proofing growth and development requires substantial resources – the global infrastructure gap globally is some \$800 billion

per year. Globally, infrastructure investments (financed by government revenues, sovereign borrowing and other sources) in 2017 totalled around \$2.5 trillion per year, but what is required for investment in power, roads, telecoms and water among other services is more like \$3.3 trillion per year. For IsDB member countries in particular, the gap is estimated to be some \$200 billion to \$220 billion per year.

This financing gap has an impact in human terms that goes beyond economic growth and resilience – it means 1.2 billion people are without electricity; 663 million people lack improved drinking water; 2.4 billion people lack improved sanitation facilities and 1 billion people live more than 2 km from an all-weather road. Pollution is also a challenge – more than 50% of all emissions are directly or indirectly attributable to deficient infrastructure.

### *Profile of the ISDB*

The Islamic Development Bank was established in 1975 and is headquartered in Jeddah, the Kingdom of Saudi Arabia. It currently has 57 shareholder member countries, all of which are developing countries and it is a global rather than a regional bank because it has shareholders drawn from countries in the Middle East, Africa, Asia Pacific region, South Asia, Europe and South America. The population of member countries totals 1.6 billion people.

The ISDB is different from many other banks in that it uses Islamic financial tools, which are asset-based. Finance is always linked to the real economy, and hence it is ideal for infrastructure investment where there is always a physical underlying asset.

In terms of its governance structure, following a major review and reform of Board governance structure recently, the Board is now focusing its attention more on strategic and less on operational issues. It constituted a Committee on Development Effectiveness (CODE) which is chaired by a member of the Board (elected by the Board), bringing the IsDB more in line with good practice of other MDBs. It reduced the number of Board meetings from 6-7 per year to four (including the one on the margins of the Bank's annual meeting) making the IsDB board the "lightest" among all MDBs. Even before these reforms, decisions were usually consensually based and the board has in fact vetoed only once on a financing decision over more than four decades of operation. This enhanced empowerment of Management by the Board is in the same direction of enhanced empowerment from senior management to middle and lower management levels and staff, especially in the field. For example, as DG in charge of countries and programs, I have three Directors in HQ and 11 Managers in the Field distributed in 11 regional hubs covering the entire membership of the Bank.

In terms of business model, the bank can be seen as a unique example of south-south cooperation. It is a solidarity-based institution as opposed to 'co-operation-based', inspired by Islamic values which call for individuals and communities to assist one another. To this end the bank offers a diverse range of different products from long-term loans to short-term trade finance. To reinforce the sense of solidarity, it is important to note that all members are both potentially recipients and donors, with no particular division of roles between them as would occur when some members were always known to be donors and never borrowers. At the end of year 2014, its total assets were \$22 billion, with authorized capital of \$148.6 billion and paid-up capital of \$7.2 billion. It has a high credit rating – with Aaa from Moody's, and AAA from both Fitch and Standard and Poor's.

Being a purely south-south bank has some limitations, in the sense that there are no AAA credit-rated individual member countries, which means the bank offers less leverage than some other banks and has a heavier reliance on its balance sheets. It has limited grants and concessional finance. It is also smaller, with 1128 staff in total, and limited field presence. On the other hand, advantages include the fact that it can be flexible in its development approach, and agility means that it can adjust quickly to changing priorities and issues. Most importantly, the solidarity objective means that loans are offered with no attached conditions – helping to reinforce the bank's legitimacy amongst members.

Regionally, the break-down of shareholding is Saudi Arabia (23.5%), Libya (9.4%), Islamic Republic of Iran (8.3%), Nigeria (7.7%), United Arab Emirates (7.5%), Qatar (7.2%), Egypt (7.1%), Kuwait (6.9%), Turkey (6.5%), and others (15.9%). The bank's stated aim is to help member countries leapfrog the stages of development and to attain international development goals, with total approvals of \$127.3 billion as of May 2017. To this end, its priority areas are to finance human development, agricultural and rural development and food security, infrastructure, private-sector development, intra-trade within member countries, and research and development in Islamic banking and finance. The bank has one of the broadest operational scopes and diversified portfolios amongst major MDBs. Of the total, energy accounts for the largest sectoral activity with 34% of the total approvals. Geographically, the bank has a broad global reach even though distribution is not even across the globe: 19 countries in MENA account for 48% of total interventions, Asia (9 countries) for 30%, Sub Saharan Africa (22 countries) for 16%, and CIT (7 countries) for 6%.

One emerging new role of the IsDB is to mobilise resources to finance development from Sovereign Wealth Funds. Of the 78 sovereign wealth funds present globally at this

time, as many as 32 are based in IsDB member countries. These SWFs have a total asset base of \$3.4 trillion, which is 45% of the \$7.2 trillion total assets currently owned by all SWFs globally. The trend of establishing SWFs in IsDB member countries is strong – over the last five years, almost half of the 11 new SWFs established globally were in IsDB member countries.

The difference between financing and leveraging is important, and the IsDB has an important catalyst role. In this vein the Bank is reporting its financing so as to show the break down between total financing and private co-financing or mobilization of resources (direct and indirect) both for all sectors, and for infrastructure in particular. In 2016 for example, of a total finance for infrastructure of \$12.4 billion, just under half came from the Bank's own account while another \$25 billion came from private direct mobilization and \$7.2 billion from private indirect mobilization. Of total financing, for all sectors and not just infrastructure, the proportions were again similar. Of \$24.8 billion in 2016, just under half, or \$11.6 billion, was from the bank's own account, meaning that the rest had been leveraged from private co-financing.

In Summary, the development paradigm is changing in many dimensions. To remain relevant, MDBs are changing their approach to development accordingly. Globally, there is a move towards Southern and Regional models and approaches. Nobody "owns" the development model but MDBs leadership (individually and collectively) are already announcing plans to change their approaches to development. This includes moving away from financing fixed sectors based on corporate strategies and towards mobilizing, facilitating, catalyzing private capital to finance diversified and changing development needs to countries. IsDB has embarked on major reforms to better respond to these realities.

## 13. How can the BRICS New Development Bank better use Country Systems – drawing on experiences from Kenya, Morocco and South Africa

*Cyril Prinsloo, Chelsea Markowitz, El Mostafa Jamea and Kwame Owino<sup>1</sup>*

The BRICS New Development Bank (NDB) puts the use of country systems at the core of its operational policies, as part of its efforts to increase the efficiency of development finance and to promote national ownership of projects. The five founding members of the NDB signalled their commitment to this approach in its initial policy documents; however, it remains untested. This article aims to share learnings from the use of national country systems (UCS) by traditional multilateral lenders in Kenya, South Africa and Morocco, and offers some recommendations as to how the NDB can potentially strengthen its UCS approach.

In discussing UCS in the context of MDBs and loans, two overarching domestic processes are of importance: public financial management (PFM) processes and environmental and social frameworks (ESF). PFM and ESF are not singular and succinct processes, but are made up of several smaller, inter-related processes, which in turn comprise various actors, institutions and legal frameworks. They differ across countries, levels of government and sectors, and tend to be dynamic. PFM and ESF are employed by governments to manage both public expenditure and external financing, and are designed to provide safeguards (financial, environmental, social, etc.) that mitigate risk and, ultimately, hold governments accountable to their citizens.

### *The NDB's experience of UCS*

The NDB does not deviate from the traditional business model used by established MDBs: it leverages paid-in capital from its member countries on debt markets, allowing it to maximise these funds and extend loans at attractive rates to its members. However, the NDB's core objective is to increase the efficiency of development finance. In line with this objective, it has signalled that it will use country systems wherever it operates to facilitate development financing more efficiently. While the NDB's approach to UCS is promising, this approach remains untested and only the implementation of projects will reveal its efficacy.

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<sup>1</sup> This briefing draws directly on a larger study undertaken by abovementioned authors as part of the Global Economic Governance Africa (GEGA) programme. Findings from the study were published and presented at the joint workshop hosted by SAIIA, GEGA and UNCTAD on 10-11 May, 2017.

In assessing the NDB's approach to UCS, three cross-cutting issues become apparent. First, the NDB places nation states at the core of its engagements, rather than itself or other borrowers (eg, private clients). For example, its Articles of Agreement note that 'the Bank shall not finance any undertaking in the territory of a member if that member objects to such financing',<sup>2</sup> meaning that if a private borrower seeks to solicit financing from the bank, and the country objects, the NDB will not proceed. In addition, it notes that '[t]he Bank, its officers and employees shall not interfere in the political affairs of any member'.<sup>3</sup>

Second, the NDB favours not only UCS but also 'use of *client* systems' (emphasis added). It extends loans to both sovereign and non-sovereign clients (eg, state-owned enterprises [SOEs] or the private sector), with a clear preference for employing borrowers' existing systems. While broad principles are identified, a great deal of autonomy is delegated to clients. On procurement, for example, the NDB suggests that 'rather than using formal competitive tendering [as is the case for sovereign borrowers], private sector clients may follow commercially acceptable procurement methods'.<sup>4</sup>

Third, there is a clear focus on capacity building and technical assistance evident in all bank policy documents. The bank's founding document, for example, suggests that to achieve its objective of mobilising resources for infrastructure and sustainable development projects, it needs to 'provide technical assistance for projects to be supported by the bank'.<sup>5</sup> Its procurement policy highlights capacity building and technical assistance in a similar fashion, while the ESF explicitly notes 'when the client has inadequate capacity to carry out necessary environment and social plans for a proposed project, the project may include component(s) to strengthen capacity'.<sup>6</sup>

Finally, the bank seems to favour a 'hands-off' approach in its lending activities. This is evident from its comfort with on-lending to financial intermediaries (FIs) in the projects it already finances.

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<sup>2</sup> NDBa, Agreement on the New Development Bank, <http://www.ndb.int/wp-content/themes/ndb/pdf/Agreement-on-the-New-Development-Bank.pdf>, accessed 20 May 2017.

<sup>3</sup> *Ibid.*

<sup>4</sup> NDBb, New Development Bank: Procurement Policy, <http://www.ndb.int/wp-content/uploads/2017/02/ndb-procurement-policy-20160330.pdf>, accessed 20 May 2017.

<sup>5</sup> NDBa, *op. cit.*

<sup>6</sup> NDBc, New Development Bank: Environmental and Social Framework, <http://www.ndb.int/wp-content/uploads/2017/02/ndb-environment-social-framework-20160330.pdf>, accessed 20 May 2017.

### *Experiences with UCS in South Africa, Kenya and Morocco*

Traditional MDBs have found, as they implement and scale up their UCS approaches, that a number of issues can be challenging. One issue relates to risk mitigation, which is especially pertinent for the NDB as it seeks to obtain an international credit rating. While domestic credit rating agencies in China have praised the institutional strength of the NDB, and rated the institution highly, strong risk mitigation strategies are vital for maintaining not only a high credit rating but also the financial viability of the institution. UCS is a core part of the NDB's operational strategy, and strong PFM and ESF processes indirectly underpin the credit rating received. Commitment of borrowing countries to the UCS agenda is also vital, which may vary across countries. The understanding of UCS in South Africa, Morocco and Kenya already highlights three different attitudes.

- **South Africa:** South Africa's political culture has traditionally championed national independence and self-sufficiency. As the economic powerhouse of the Southern African region, South Africa is less reliant on MDB loans than other countries, while also contributing to the concessional windows of key MDBs, which is indicative of its economic position. Conversely, as a middle-income country (MIC) with general political stability, strong country systems and the ability to pay back loans, South Africa is highly sought after by MDBs. This gives it significant leverage in negotiating loan terms with MDBs. Thus, in South Africa, the concept of UCS is viewed as a right rather than a privilege. The National Treasury handles all loans from MDBs and negotiates the financing agreements. Among government stakeholders, UCS is widely regarded as necessary to ensure that South Africa's developmental objectives are protected and promoted. Conditionalities put forward by MDBs are viewed with suspicion and often result in reconsideration on South Africa's part.
- **Kenya** - In Kenya, PFM is governed by Chapter 12 of the country's Constitution. The Constitution also outlines laws on environment. The country thus has robust systems for both PFM and ESF in place and each these systems meets development partner standards. Nevertheless, the government is much less likely to insist on full UCS than in South Africa, and donor systems are used in parallel to the existing country systems, with development partners overseeing every project phase. Government stakeholders strongly advocate the adoption of a 'hybrid' system in the use of PFM and ESF. This consists of a combination of MDB requirements and Kenyan laws, where MDB requirements can be adapted to the Kenyan context in appropriate cases. The general government sentiment is that Kenya should be (and is, for the most part) compliant with international standards as it is a capable lower middle-income country (LMIC) that should



set an example for its region. It has also updated its legislation in recent years to ensure that this is, in fact, the case. An area in which there is still room for improvement concerns the procurement system, whose process is strict and therefore leads to delayed project commencement and completion.

- **Morocco** - Morocco has a smaller economy than South Africa but shares many of South Africa's MIC characteristics, namely a well-developed and diversified economy, strong financial sector with a quite well-developed banking sector, well-established legislation in line with international best practice and reasonable capacity in public institutions to carry out the government's policies and mandate. However, Moroccan attitudes towards UCS are more ambivalent, with clear instances where public institutions reject the imposition of external rules, but also cases where there is a realisation of shortcomings in domestic processes, and an acceptance of the imposition of external rules. Two inter-related areas where room for improvement exists are capacities for public tendering process, which could be reinforced, and the procurement system. The latter is characterized by the existence of more than 240 rules for tendering and bidding, given that each institution or agency has its own systems, and lack of complaint mechanism in public tendering. Another deficient aspect is the current focus on rules and procedures and a possible way forward would be to promote a new culture based on results instead.

Once more countries have joined the NDB, commitment to the UCS agenda can be strengthened by the bank's in-country presence. Having a physical presence in a country, with offices staffed by locals who intimately understand the business culture and operating environment, and where close networks with key stakeholders can be built, is vital for greater UCS and commitment to this agenda. Not only do local staff assist in mitigating risks for MDBs but their familiarity with domestic systems have also often made them key proponents of greater UCS. Country offices' attitudes towards UCS often contrast to that of headquarters, which are further removed from the environment.

#### *Procurement and capacity building*

Procurement is an important part of UCS (as evidenced by the country examples), an aspect that may often be contentious in the relationship between MDBs and borrowers. Considering that it holds significant process risks for development projects, MDBs typically prescribe procurement guidelines. However, procurement rules dictated by MDBs have tended to conflict with the development policies of borrowing governments (eg, using procurement as a developmental instrument to promote the participation of small and medium enterprises or marginalised groups) or have resulted in domestic

companies being excluded from MDB-financed projects. The NDB's procurement guidelines recognise these shortcomings of past approaches by dictating UCS in the case of public sector operations or client systems for private sector operations.

Capacity and capacity building, in turn, have significant implications for facilitating greater UCS. One needs to consider the capacity of both MDBs (number of staff and required technical expertise) and borrowers to employ UCS. Capacity building should also be holistic, focussing on strengthening country systems rather than individual projects. It should also focus on both strengthening institutions and capacitating individuals. While capacitating individuals contributes to better functioning of systems, they are often tempted to leave the public sector for higher salaries in other sectors. It is therefore important to also strengthen governance processes and operations. At the same time, the capacity of civil society should not be neglected. Civil society plays an important role in keeping government accountable to domestic PFM and ESF processes, often on behalf of marginalised or disempowered individuals. This is important where MDBs relinquish more control to governments through UCS. The encompassing nature of capacity and capacity-building requirements poses significant challenges for the NDB, notably in relation to its intention to keep a small staff.

The NDB would do well to support country-specific capacity-building strategies, developed by countries themselves (to enhance buy-in and appreciating local context), that strengthen country systems as a whole, rather than just individuals. It should further take into account in-country ability to provide that capacity (eg, university courses), and civil society. It should be noted that enhancing country capacity will benefit all development partners (through better management of loans or grants) in addition to ensuring that countries are better equipped to manage their public finances.

The NDB also needs to consider financing capacity-building efforts. One option is to leverage a marginal levy on loans to raise additional funds for this activity. While making loans more expensive (and hence less attractive to borrowers) may be discouraging, the vital role of capacity building should justify this marginal cost. Another option would be to employ 'profits' from NDB loans towards capacity building. Unlike many other MDBs, the NDB does not have a concessional window that requires replenishment every other year. While other MDBs contribute proceeds made from loans above and beyond what covers their operational costs to finance their concessional windows, the NDB can gear these proceeds towards capacity building. Again, the appetite of shareholders – both founding and potential new – to such an approach would have to be tested. Lastly, the NDB could also consider creating a dedicated capacity-building fund. The bank's Articles of Agreement provides for special funds to be set up, such

as the mooted project preparation facility. A similar fund could be created to support capacity building.

In sum, the NDB's nascent approach to UCS is encouraging. However, there is a wealth of experience and lessons that can be learned from other MDBs. This will become more important as the NDB expands its membership and the relatively lean organisation has to support implementation in countries at different stages of development. Below follows a set of recommendations concerning NDB's use of UCS:

- Member countries' PFM and ESF processes indirectly underpin the NDB's financial reputation. It is therefore vital that it supports member states where their domestic processes fall short. Where the NDB relies on financial intermediaries (FI), adequate monitoring of FIs' and subprojects' compliance with safeguards is required.
- Traditional quantitative methods of measuring equivalence and acceptability of country systems vis-à-vis MDBs' have proved cumbersome and expensive. The NDB, given its limited membership, should make use of in-country experts and staff to qualitatively assess country systems and identify shortcomings.
- Discerning member states' commitment to the UCS agenda is vital. Country or regional offices can assist with building trust between parties to increase the uptake of UCS, provided they are adequately empowered.
- Placing UCS at the centre of the NDB's procurement policy is encouraging. However, this should be supported by adequate post-award contract monitoring.
- The NDB could cooperate with other development partners that have displayed a keen interest in strengthening the capacity of governments, while exploring avenues for financing such efforts.
- Broader society plays an important role in keeping governments accountable to domestic PFM and ESF processes, which is important where MDBs relinquish more control to governments through UCS.

## 14. Africa's regional trade, monetary and financial integration: An Overview

*Stephen Karingi*

This article presents an overview of the process of regional integration in Africa, including its philosophy and underpinning. It discusses, in particular, the state of play of integration and emphasizes infrastructure development as a key challenge to be addressed. It also shows where countries currently stand in terms of monetary and financial integration in the region.

The Abuja treaty, signed back in 1991 by member States of the Africa Union, aimed at promoting economic and social development on the African continent through the creation of an African Economic Community. In the spirit of the treaty, the process of regional integration in Africa has involved several phases, with clearly specified key targets (see table 1).

**Table 1** The Abuja treaty

Phases	Duration	Key Targets
1	1994-1999	Strengthening of existing regional economic communities (RECs), and their creation in regions where they do not exist
2	1999-2007	<ul style="list-style-type: none"> <li>• Stabilization of tariff and non-tariff barriers, customs duties and internal taxes in each REC</li> <li>• Stabilization of tariff and non-tariff barriers, customs duties and internal taxes in each REC</li> <li>• Schedules for the removal of such barriers</li> <li>• Harmonization of customs duties</li> <li>• Strengthening of sector integration</li> <li>• Coordination and harmonization of RECs' activities</li> </ul>
3	2007-2017	Establishment of free trade area (FTA) and a Customs Union (CU) in each REC
4	2017-2019	Coordination and harmonization of tariffs and non-tariff systems among RECs leading to a continental CU
5	2019-2023	<ul style="list-style-type: none"> <li>• Common sector policies</li> <li>• Harmonization of monetary, financial and fiscal policies</li> <li>• Free movement of persons and rights of residence and establishment</li> <li>• Proper resources for the Community</li> </ul>
6	2023-2028	<ul style="list-style-type: none"> <li>• African Common Market;</li> <li>• Pan African Economic and Monetary Union</li> <li>• African Central Bank and a Single Currency</li> <li>• Pan-African Parliament</li> <li>• African Multinational enterprises</li> </ul>

Source: Author's elaboration, UNECA.

Up to now, progress has been made over three phases, whose key targets included the strengthening of regional economic communities (RECs) (phase 1994-1999); stabilization of tariff and non-tariff barriers, customs duties and internal taxes in each REC, strengthening of sector integration and coordination of REC's activities (phase 1999-2007); and the establishment of a free trade area (FTA) and a Customs Union (CU) in each REC (phase 2007-2017). For the subsequent phases, the levels of ambition gear up, with the coordination and harmonization of both tariff and non-tariff systems across RECs, eventually leading to a continental CU (phase 2017-2019); macroeconomic convergence through harmonization of monetary, financial and fiscal policies, and free movement of people and rights of residence (phase 2019-2023); and, finally, the establishment of an African common market, a Pan African Economic and Monetary Union with an African Central Bank and an single currency, and a Plan-African parliament (phase 2023-2028).

While the regional integration agenda for Africa looks quite ambitious, especially in view of the well-known challenges of economic, social and geographic nature (just to mention a few) that characterize the continent, the question is why regional integration remains a development imperative in Africa. Essentially, the rationale underlying this imperative is based on the belief that integration is a vital vehicle for overcoming the constraint of small economic size, which hampers African countries' ability to industrialize efficiently; also, it can be seen as a practicable way of minimizing the costs of African market fragmentation; and, equally very important, it can help attract foreign investment and technology, in particular those motivated by economies of scale. Moreover, regional integration can also create opportunities, by: lowering transaction costs to business, expanding markets, pooling regional resources, creating economies of scale in production, increasing efficiency in resource allocation, becoming part of regional and global value chains by exploiting platforms offered by RECs, such as FTAs, and harmonizing policies, regulations and standards.

In promoting regional integration, RECs constitute critical components of this process. As hinted earlier, the Abuja Treaty and Constitutive Act provide the political vision for Africa's integration, with the RECs serving as the building blocks. They provide a framework for collective action and their treaties cover a broad range of sectoral, institutional and policy goals and targets. RECs are also expected to evolve into free trade areas, custom unions, and through horizontal co-ordination and harmonization, eventually culminate into a common market embracing the entire continent. Several reasons underpin the notion of building blocks for Africa's integration. These include history of cooperation among the African countries, colonial legacy and the fact that block members are adjacent to one another, which shortens the distance of physical

and infrastructural linkages and thereby can result in substantial cost savings in such areas as trade, transport and communications, and energy resource pooling.

Table 2 summarizes the state of play of different RECs. It shows that most of them have as ultimate goal full economic union, but still find themselves at different stages of integration.

**Table 2 RECs as building blocks: State of Play**

AU recognised RECs	Number of countries	populations (Millions)	Objective	Current stage
UMA	5	84.2	Full economic union	Free trade area no achieved
ECOWAS	15	282.9	Full economic union	Custom union
ECCAS	10	127.2	Full economic union	Semi-FTA
COMESA	19	416.1	Common market	Custom union
EAC	5	127.1	Full economic union	Common market
IGAD	7	200.5	Full economic union	FTA being contemplated
SADC	14	269.2	Full economic union	FTA
CENSAD	29	514.6	Free trade area and integration in some sectors	FTA not achieved

Source: Author's elaboration, UNECA.

Going beyond this general picture, the question is how much progress has been achieved. Although progress has generally been mixed across sectors, RECs and member states, a more detailed analysis permits the identification of various positive outcomes so far. These include, among RECs, trade liberalization and facilitation (e.g., COMESA); free movement of people (ECOWAS); infrastructure (SADC and EAC); and peace and security (ECOWAS and SADC). Regional integration efforts have also led to energy pooling and distribution initiatives among countries. Examples are SADC Power Pool, and the ECOWAS Power Pool and Gas pipeline projects. Physical connectivity, although still relatively poor, has improved in many areas. In addition, Yamoussoukro Decision on air transport liberalization resulted in the granting of more traffic rights, and the opening of the African air space for more competition and more choice for air travelers.

Key challenges remain, however. A first one is how to ensure the functionality and dynamism of the RECs. The second is how to link trade liberalization, an area in which important progress has been made, with production and productivity and how to dynamize intra-African trade, which remains low. The third, and perhaps most critical challenge, is about infrastructure development. Financing and implementing the

Programme for Infrastructure Development in Africa (PIDA) is imperative. Addressing these challenges is important to overcome the continent's limited production and associated supply-constraints, and its inadequate infrastructure.

Thus, although much remains to be done, the good news is that important initiatives have been undertaken to address some of these challenges to Africa's integration. These include the articulation of a long-term vision for infrastructure development in the context of PIDA, with inclusion in the latter of a Priority Action Plan aiming to expand significantly physical infrastructure by 2020, with a focus on transportation sector (roads, Trans-African Highways, port capacity); capitalization on the significant intra-African trade in manufactures to promote commodity-based industrialization; articulation of an institutional architecture; and work on exploring different financing options, such as an African Infrastructure Development Fund, Development of African Bonds Market (Diaspora Bonds), Africa's Credit Guarantee Facility, Public-Private Partnership schemes and, very importantly, domestic resource mobilization, as African countries themselves fund 50% of infrastructure projects on the continent.

Among the areas just mentioned, one that deserves particular attention is intra-African trade, which, measured by imports, accounted for only 14% of total African foreign trade in 2013. Developing intra-regional trade is believed as key to unlocking the continent's industrialization potential. Indeed, higher intra-regional trade is associated with higher shares of regional value-added. It is important to bear in mind that regional integration is not a zero-sum game: if one country gains at one stage of production, other countries can integrate value chains at other stages, complementing each other. A caveat is that intra-regional trade alone cannot be the answer to the development of manufacturing capacities in the region.

### *Monetary and financial integration*

To support regional integration in markets of products and services and ensure the process is stable and sustainable, institutional development is needed. In this regard, a key area for further work is on monetary and financial integration. A key element that lays the ground for such integration is macroeconomic and policy convergence. This is why the latter is among the key objectives of RECs. Attainment of macroeconomic convergence would lead to a stable macroeconomic environment and have positive impacts on the region's economic growth. Accordingly, agreements among member States of RECs have taken place on a set of variables for macroeconomic policy convergence. These agreements obligate each member State to implement and maintain fiscal and monetary policies that are transparent, consistent and contribute towards the achievement of the convergence criteria. Also, each member State

undertakes to formulate and implement sustainable fiscal and monetary policies that minimize negative spillover effects in any other member States. The macroeconomic variables and factors of particular relevance for macroeconomic policy convergence include inflation control, fiscal restraint, maintenance of sufficient levels of external reserves and growth performance. As part of this process of integration, Africa aims for the formation of monetary unions, in addition to the already established ones – CEMAC and UEMOA, and the integration of payment systems.

Finally, but not less important, work is needed to support financial sector development. In all RECs, the ratio of population per bank is very high and the consequences are the failure of countries to mobilize sufficient levels of domestic savings, which also affects their ability to raise investment rates. In the area of capital markets, most countries within each REC have development banks, except in CEMAC and UEMOA, which have region-wide development banks. COMESA also has a regional bank (TDB), and SADC has the Development Bank of Southern Africa, which has taken the responsibility for serving the interests of all member countries.

A main conclusion is that, although much remains to be done, it could be said that Africa is turning the corner. Regional integration remains a key priority of African leaders in order to achieve the dream of a continental unity and economic transformation. Despite the obstacles and challenges, Africa's political leaders acting through their institutions remain committed to the vision of the African Common Market and the African Economic Community as manifested in recent decision and efforts to fast track the establishment of a Continental Free Trade Area.





# PART 3: THOUGHTS AT THE BIRTH OF THE BANK OF THE SOUTH



## 15. The Bank of the South as a Mechanism for Financing and Regional Integration: Activities in the Operational Phase

*Pedro Buonomo*

This article aims to share some reflections on the start-up of the Bank of the South. It has been over ten years that the presidents of seven countries of the Latin American continent signed the Founding Treaty of the Bank of the South, and the bank has by now established its Executive Board, signaling a successful conclusion of a process that started back in 2007.

The concretization of the Bank of the South is part of a new financial architecture in the Latin American region. It is a new financial instrument that is compatible with sovereign development as opposed to dependent development. That is, it is a tool to be used to support the endogenous development of the region's productive sectors.

To give some context, in the 2000s, most of our countries experienced several years of significant economic dynamism, explained for the most part by exogenous factors such as the increase in the prices of the region's commodity exports but also by adequate economic policies, perhaps undertaken with much more sovereignty than in the past. This period of economic growth also was accompanied by an unprecedented significant reduction in poverty in most of the region's countries. Some countries did better than others, in terms of reduction of poverty in its most extreme forms. There are also indicators showing a reduction in inequality in the most unequal region of the world, a sad privilege that Latin Americans have had for a long time. Though, it must be said, a reduction in inequality, which basically manifests itself in the calculation of a Gini index, and which has to do with income inequality, is not evidenced at the level of the distribution of wealth. In fact, wealth continues to be concentrated both in the world and in Latin America, and countries that during the successful decade improved income distribution have not designed policies to improve the redistribution of wealth, in a world system that tends towards concentration.

In addition to the issues of income distribution and of concentration of wealth, as Studart in this volume makes the point, during those years of economic growth Latin America has not questioned the role the international economic order has historically had in the region. And making reference to Professor Dos Santos (see also in this volume), the continent has not been able to move beyond production of raw materials and selling

products abroad with greater added value. In a difficult international economic system, the region has continued with the same productive matrix, which is one of the great challenges it faces going forward.

In this context, the Bank of the South, today, has the possibility of starting working as a tool for the sovereign development of Latin America, a tool that creates opportunities and also new challenges and forces countries to reflect on what the priorities are and on what aspects they have to act – while aware of their possibilities, and of their strengths and weaknesses. It is a difficult, complex issue, since the challenges are many and the tools available are not too many.

It should be noted that ideology is a fundamental part of social and political relations; not knowing it would not be serious and would not be honest. There were those who preached or pontificated the end of history at the end of last century and one knows what happened. In other words, ideologies are in force, they are behind proposals, projects and policies, and this has to be recognized.

The Bank of the South is a project that has an ideological vision. This is how its promoters see it and so is how those who are suspicious of it. It is an issue to be had on the table and to be faced without denying its objectives. At the same time, it should be treated with intellectual and technical honesty, accompanied with efforts to prove that the project can serve the great majority of Latin American society.

As the eminent Ecuadorian economist Pedro Páez has said, “there is a conservative offensive to what we are proposing to the benefit of the great majority of people of our continent.” In this vein, the challenge is to try to give answers through our own policies and instruments; answers that other policies do not give and somehow do not even propose to give. There are concrete, specific elements that explain a little bit the opposition of certain sectors regarding our proposals. Obviously, we live in a market system in which global and more powerful groups try to maximize their rates of profit, relying on an international financial system in which what they call sovereign debt is not sovereign in the sense of the sovereignties to which Arauz in this volume referred, but sovereign in the sense that it benefits those who set the rules of the debt markets.

### *Key themes for the Bank of the South*

After this general reflection, I want to refer to three or four specific themes that I believe are consistent with the Bank of the South’s strategy. Its Founding Treaty speaks of a bank to finance the development of the region, with the aim of advancing the different dimensions of sovereignty: food sovereignty, technological sovereignty, energy

sovereignty, sovereignty of knowledge, educational sovereignty. This approach clearly differentiates the Bank from other multilateral organizations. It gives it meaning and forces it to be consistent with it.

Other two or three priority areas which I believe are important the Bank works on are as follows.

The first is Infrastructure. As Studart in this volume clearly states, infrastructure is a basic element of development banking and is considered a key determinant of competitiveness. The gaps our countries have in infrastructure investment are a very serious handicap that harms economic growth. It is also known that reducing investment in infrastructure implies a deterioration cost that is much bigger than the cost of its future replacement. Therefore, investment in infrastructure is a key priority. The Bank of the South should have in this respect a differential but also complementary character with other regional development banks that invest in infrastructure.

In addition to improving competitiveness, infrastructure has two other roles: it contributes to equity and productive integration. Indeed, infrastructure plays a significant role in terms of access to equity. It is through infrastructure that it is possible to have access to services, public goods, education, health, etc, all important to achieve equity. This role is not solved by the market. The market does not internalize that type of goal. Hence, for the Bank of the South, infrastructure must consider accessibility as an equalizing factor. In addition to equity, infrastructure investment clearly contributes to the objective of economic integration. It is not possible to visualize an endogenous development of our productive sectors, or a change in the productive mix or in the conformation of our products, without thinking about productive regional integration, an aspect on which the region has advanced very little despite some efforts.

In general, regional integration has worked best where there is integration of companies, but non-integration of nations. The challenge is to invest resources in project formulation. Without projects, there is no possibility of channeling funding. The scarcity of project formulation and development is a major weakness. Then channeling resources for the formulation of projects and possibly leveraging the financing of projects in those regional infrastructures is key to underpin regional productive integration. In that sense, we must recall the fact that UNASUR's South American Council of Planning and Infrastructure (COSIPLAN) has identified eight infrastructure projects at the regional level that do not yet have funding. Possibly the explanation for this is that the financing available for infrastructure prioritizes those projects that have an attractive economic return.

Another priority area of work for the Bank of the South is knowledge sovereignty. Latin America is absolutely dependent on generation and appropriation of knowledge, research and technological development from advanced countries. This is a critical issue and demonstrated by the fact that, increasingly, the discussion of free trade treaties appears to include the subject of intellectual property, patents and everything related to the appropriation of knowledge. For many decades, the drug industry does not do research on cure for diseases; instead, it does research based on the profitability of the products. This behavior choice is not surprising but, still, it is shocking how that translates into people's quality of life. Therefore, the subject of knowledge sovereignty, and the search for instruments that as a development bank one can use with this objective, is very relevant.

Finally, a third priority area, perhaps less relevant in terms of quantitative significance but from my point of view very important, is what has to do with financial support and the development of technical capacities to assist alternative forms of productive development. That is, different ways of production where the social relations of production such as working capital are not the dominant ones, but, rather, relations linked to the social economy, cooperativism, the self-managed company, one that has a different sense of the appropriation and distribution of wealth. The relationship between capital and labor and how they are employed as productive factors basically has to do with production relations, so the Bank of the South must promote these types of projects, and I also go on to highlight the importance of generating technical capacities, because although many times it is not object of financing, the technical capacity to structure and manage projects is.

To conclude, the Bank of the South has to begin modestly, little by little, but it must remain loyal to the objectives for which it was conceived and for which it was thought by its founders. Although it cannot be expected to generate a significant impact with its policies due to the own economic restrictions it is facing in its beginnings, it does have to maintain its course in honor of the regional leaders who conceived it.

## 16. The Bank of the South: Its transformative role and the five sovereignties

*Andrés Arauz*

Latin America has always been vulnerable to unfavorable terms of trade and has not been able to form an agenda of associativity on the productive front in order to generate regional value chains and project itself into the world. The region has not been able to reach a minimum consensus on the strategic management of natural resources, royalties, effective tax rate, or common wage policy. In this sense, the reason to open a bank oriented towards the needs of the South is that it is necessary to propose a strategic integration of the continent into the world and to promote regional economic, productive and social integration. This need and indeed urgency remains the same as ever, and is perhaps even greater at this time. The proposals for development of productive capacities, human talent, and progress in terms of sovereignty, are still there and have been there for the last 15 years.

By now, the Bank of the South has travelled a long path in terms of institutional development over the past ten years. Perhaps the only advantage of the so many delays in setting up the bank has been that it has also given its creators the time to advance a great deal of theory and practice, to seek the best experiences, to organize a vast number of seminars and workshops with political and economic authorities from international and non-governmental organizations to academia and to be able to build a normative, technical and knowledge platform to carry out this important undertaking, as is the Bank of the South.

The time that has elapsed has allowed for the strengthening of other parallel and necessary institutions for the functioning of the bank. For instance, at UNASUR, there is the South American COSIPLAN, which has now developed a very broad portfolio with more than 478 projects, representing \$156 billion in investments. This portfolio is of strategic importance for the integration of the region<sup>1</sup>. Hence, the passage of time has made life easier for the Bank of the South because it already has an agenda of strategic projects about which all countries have said: “We need financing for these strategic projects, which will help consolidate integration among our countries.”

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<sup>1</sup> Report of the COSIPLAN Project Portfolio, 2016.

A criticism raised towards the Bank of the South concerns its size. Evidently, the bank's authorized capital of \$20 billion may not be that large. But even the BRICS New Development Bank itself was not born as a giant bank; the first contribution of each member country in the first year of operation does not even represent 1% of its authorized capital<sup>2</sup>. This is normal, since these are institutions that start small and then grow in their quest to seek to transform the reality of the international financial system. Thus, one of the main tasks that these institutions have is not necessarily to start with a large capital but, rather, to raise new ideas and ways to approach international relationships and policies. Besides, the issue is not just about capital contributed by the member countries but to seek to raise additional resources, such as the more than \$1 trillion Latin American countries have deposited in the rest of the world, a good part of which corresponds to their Central Bank reserves. Thus, the bank cannot simply remain a lender. It must seek to transform reality to convince private and central bankers of their great homeland and to invest part of their resources and reserves in institutions of the South. The potential is immense. These are not small-scale undertakings but radical transformations of the functioning of the system, something that has been achieved in other spaces and other continents over time.

*Bank of the South agenda: the five sovereignties*

The agenda of the Bank of the South, which is contained in its Constitutive Agreement, is organized in what we could call the "five sovereignties". The Constitutive Agreement is one of the first to be quite ambitious in proposing that projects to be financed should underpin these sovereignties but with an understanding framed more in the new Latin American regionalism, where the sovereignties are conceived not only in terms of each country but in regional terms. Obviously, this will strengthen the interdependence between countries and increase the region's level of autonomy relative to the rest of the world<sup>3</sup>. The five sovereignties are:

- a. Food sovereignty, which might take the form of a system of silos managed locally in cooperation with various levels of government, agricultural producers, etc. All of this would be to contribute to satisfy the nutritional needs of the population with strategic planning.
- b. Health sovereignty, which might be about promoting strategic projects linked to, for example, drugs, biological development, drug development and production to meet the needs of the region's countries in the field of public health.

<sup>2</sup> Bank of the South Constitutive Agreement, 2016

<sup>3</sup> Bank of the South Constitutive Agreement, 2016



- c. Natural resources sovereignty, which implies being able to exercise the relative market power that the countries of the South have in terms of their vast countryside, their abundant lands and agricultural resources and non-renewable mineral resources, in order to leverage industrial, technological and knowledge development, and to seek a better international insertion in global value chains.
- d. Energy sovereignty, in order to consolidate the immense paradox found in the continent. In theory, the region can quietly meet all its energy needs with energy generation; nevertheless, it often ends up as a gigantic importer of energy (e.g., fossil fuels) from other parts of the world.
- e. Knowledge sovereignty, to be sought through leveraging a southern knowledge fund to finance education, science and technology, innovation and cultural projects, based on a framework program that allows for interweaving among the various countries' academic, research and policy institutions, involving not only national but also research projects of regional nature. This would allow for the generation of the region's own knowledge and needs and not necessarily as a result of the philanthropy originated in the north. This will also help strengthen the identity of the region's citizens.

Beyond all these approaches to sovereignty, there already are the projects of COSIPLAN as just mentioned, which speak very well of the processes of integration in the region. Some projects have been agreed: the Great Continental Railway Network to transport passengers and freight between countries, the fiber optic network, the network of aqueducts, the water network and waterway projects, and a series of bridges and roads.

### *Connecting with the rest of the world*

A final consideration is that the Bank of the South cannot be thought of in isolation. In this operational phase, it is very important that strategies of alliances are established with other financial bodies operating in the region, with the aim of developing, for instance, syndicated loans while consolidating the bank's institutionalism and expertise, but also seeking to capture resources and building alliances with development banks from other latitudes and from other continents, that can really turn the Bank of the South into the financial platform linking South America with the rest of the world.

## 17. The Bank of the South: A Bank for a better world

*Eudomar Tovar*

Previous articles in this volume have stressed the economic crisis Latin America has experienced. The point I would like to start with is that it is also about a social crisis, framed in unprecedented levels of poverty and concentration of wealth; and, of course, this brings a very strong constraint on human development, both in the present and in the future, an issue also observed in the international context. In face of this reality, a set of actions needs to be adopted in order to avoid possible impacts of greater magnitude in the region's economies.

Since a while ago, rising interest rates and dollar appreciation in the United States has allowed the United States economy to attract additional resources. As a consequence, Latin America is already facing a dollar scarcity, which will have quite harmful impacts, especially in those more indebted countries. The reason is simple: if there is a shortage of dollars and there is an increase in interest rates, the service of the debt will be more costly and the requirements to obtain resources to service it will also become more expensive.

Of course, here comes the theme of the Bank of the South and the new regional financial architecture. It is important to create such a new architecture, not because the one that exists is useless but because it does not cover the needs of Latin America in the most difficult times. Moreover, it imposes a set of negative conditions that affect adversely our activities and create social conflicts. Under the current financial architecture, the governance structure has not been renovated. Consequently, poor decision making of previous years continues to proliferate. This, of course, has severe consequences for our countries. In this context, the Bank of the South requires political will in order to become fully operational.

In the region, specifically in South America, international reserves have been over \$500 billion. These reserves are parked in the international big banks and big corporations financing projects of their own interest. Meanwhile, Latin America and especially a few South American countries are going through very difficult times. In a region that produces natural resources and that countries compete with the same products in the international markets, the result is extremely serious. Practically two-thirds reflect products with a low value added, especially raw materials. Of course, despite the efforts to produce them, they are not sufficient for what is required in the region. Therefore, it is necessary that the Bank of the South be promoted with no objections to credits, except those necessary for logical reasons as it is contemplated in the Bank's statutes. So, it is

essential that the decision-making process contemplated in the Constitutive Agreement should be totally democratic, with each country having a vote and with no blocked decisions by those having the veto power.

Where should financing be directed to? Undoubtedly, in the context of what is established in the Convention, it should be oriented to the achievement, already mentioned in Arauz's article in this volume, of food sovereignties. This is extremely important in the technological, knowledge and knowledge development context in which we are living. It should also be oriented towards energy and, of course, the most important, our natural resources and their sovereignty.

The Bank of the South will start operations in a context of restriction of resources. Within this environment of resource restriction, the bank's projects should be prioritized. From my point of view, financing should go to food and to transforming raw materials in order to generate value added products that can then be placed in the international markets. This should be done in an equitable way to ensure fair competition with other international products. Moreover, financing should be directed to small and medium-sized enterprises. We know what and how to do it. We must have the political will and, in addition to that political will, the technical interest; in the framework of a moral story, we must above all to have a will to do things. This is what is needed in the region: to leave the egotism or particular interests and to seek instead the interests of all the citizens of the region's countries. That is extremely important. The fact is that the only way to avoid the consequences of the international financial crisis is through the process of integration.

In this context, we ask ourselves: since when has integration been discussed in the world? Even the liberator Simón Bolívar made important progress in the processes of regional integration. At one moment there was political will to create UNASUR, CELAC, ALBA and I say political will because I am convinced that political will is the only remedy that makes integration reality. I have lived it in my own flesh with SUCRE, which is a unit of account that was created in 13 months because there was the political will of the Presidents of the member countries ALBA and non-member countries, such as Ecuador. Today, SUCRE is happily operating despite being demonized by the particular interests of large corporations and by people who do not even realize its reality, as dos Santos says in his article in this volume. And as mentioned by Arauz, taking advantage of the region's abundant resources, the Bank of the South should start with food, social and productive sectors, seek synergies with the national development funds or banks, including through covenants to co-finance large (and small) projects, such as those in infrastructure. This can be done, for example, with CAF. As a development bank, CAF

is a strong arm that could collaborate or help since, after all, they have resources and the Bank of the South should take advantage of the complementary role CAF can play.

There is also the BNDES of Brazil, as a financial powerhouse. The bank has financed projects in Venezuela, Nicaragua and many other countries. Of course, we cannot forget the Bank of the BRICS, which is an interesting and important body that will provide many resources, so it is also necessary to make agreements with this new institution. In addition, it is important to leverage the Bank of the South's capital through different alternatives, such as Class B and C shareholders; synergy with regional banks; agreements with international banks; issuance of obligations.

In short, to conclude, if we want a better world, if we want a better Latin America and South America, we have to integrate ourselves, so that we can achieve what we all want: *Welfare for our peoples and for the emerging developing countries, and, above all, true development.*

