Chapter VI

Regional development finance: progress and challenges

A. INTRODUCTION

With less than a decade left to implement Agenda 2030 and agree on more ambitious emissions targets to prevent a climate meltdown, neither multilateral financial institutions nor private capital markets are providing the scale of financial support needed by developing countries to meet these goals. Scaling up on both fronts will be key to building sustainable development pathways, but many governments and industries will, in the meantime, rely on "their" regional institutions to finance transformative investments and deliver public goods that are beyond national capacities alone.

There are now more choices for this than there used to be, thanks to the creation of new regional financial institutions and arrangements and the expansion of existing ones. Over the last two decades, through regional development banks, regional foreign exchange reserve funds, regional currencies and new regional financial mechanisms and instruments, trillions of dollars have been added to the global pool of finance. Some of these institutions are lending more than the Bretton Woods institutions, and some of the most innovative are owned and led by countries in the South (Grabel, 2018; *TDR*, 2018, 2015; Gallagher and Kring, 2017; Barrowclough et al., 2020, 2022; UNCTAD, 2018a, b).

There are other benefits of regional arrangements, including the advantage of pooling scarce resources, tapping into local knowledge of capacities and needs, increasing the size of local markets and strengthening "voice" in multilateral forums. For smaller economies, these benefits can be huge, but even the larger developing countries in a regional arrangement can derive advantages. At the same time, the definition of "regional" is becoming more amorphous. Either due to the fact that easier communications have broadened horizons or simply because development financial institutions (DFIs) which focus tightly on their own region are more vulnerable to external shocks and financial constraints, many seek members and operations outside their region.

This chapter surveys some of the most important trends in regional DFIs and their evolving role in the global financial architecture, and explains how they meet the needs of their members. It finds that no single approach offers the best formula of success: differing structures may be more appropriate in some regions than others. In Asia, the Chiang Mai Initiative Multilateralization (CMIM), the New Development Bank (NDB) and the Asian Bond Markets Initiative (ABMI) emerged without a formal political framework; whereas in other regions, the regional financial institutions can be nested in broader political arrangements. Whichever structures are chosen, the common challenge is one of scaling these efforts up to meet the multiple challenges facing developing countries over the coming decade and beyond.

Section B of this chapter summarizes what is available at the regional level to developing countries in terms of short-term foreign exchange and balance of payments liquidity, using the lens of the recent Covid-19 experience to show that different countries have very different arrangements and ways to cover liquidity needs in times of crises.

Section C delves into the long-term, patient and counter-cyclical finance available in regional development banks and funds, showing their different experiences during Covid-19 in terms of lending and points to new roles being played in terms of research and development innovations. It builds on the evolving views and understandings of regional institutions and the benefits of regionalism, as described earlier in Chapter IV. Specifically, the latest phase in the evolution of regional development banks is marked by the changing and more prominent role of the South-led institutional initiatives. Section C details the consequences of these trends.

Section D discusses some important ways of scaling up these regional institutions and arrangements so they are better equipped to meet their members' needs, including the use of Special Drawing Rights (SDRs) from countries that do not use or need them, as well as regulatory reforms that can remove current constraints. Part E draws key policy recommendations.

B. REGIONAL PROVIDERS OF FOREIGN EXCHANGE LIQUIDITY IN TIMES OF CRISIS

In the three decades after the Bretton Woods Conference (1944), the International Monetary Fund (IMF) was the only available source of financing to cover balance of payments difficulties for the majority of the world's countries. From the 1970s onward, regional financial arrangements (RFAs) created by emerging and developing economies, the Arab Monetary Fund (AMF) and the Latin America Reserve Fund (FLAR) emerged as alternative lending sources, anticipating a wider role for regional arrangements alongside multilateral and bilateral arrangements, in what is today called the global financial safety net (GFSN).

In part, their emergence represented reactions to oil price volatility and debt crises in Africa and Latin America. A second wave of RFAs gathered momentum following the Asian financial crisis of the late 1990s and the global financial crisis (GFC) of 2007–2008, which prompted the creation of a number of diverse institutions that could provide emergency liquidity at various levels and reinforced a sense that South-South solutions could offer special features for their members as a "first resort" to which they could turn in times of crisis, complementary to the "last resort" of the Bretton Woods institutions.

Rather large regional funds were created or previous funds were enlarged in Europe and Eurasia, such as the Eurasian Fund for Stabilization and Development (EFSD), alongside developing region initiatives, such as the CMIM and South Asian Association for Regional Cooperation Swap Arrangement (SAARC), or transregionally between emerging markets, such as the BRICS countries (Brazil, Russian Federation, India, China, South Africa), who created a Contingent Reserve Arrangement of their NDB (*TDR*, 2015; Gallagher and Kring, 2017; Grabel, 2018; Mühlich and Fritz, 2021; Barrowclough et al., 2022).

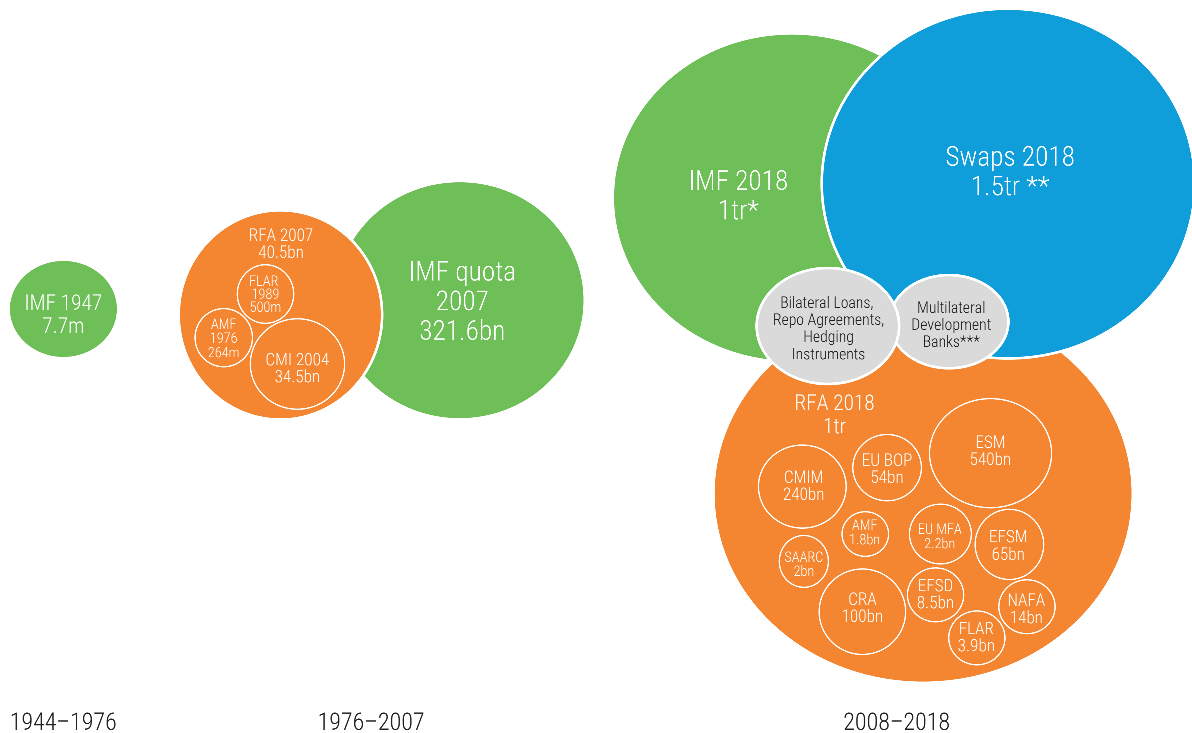
By 2020, the GFSN had expanded to ten times its size at the time of the GFC, offering unprecedented capacity for crisis prevention through a variety of sources (table 6.1). RFAs offered as much as the equivalent of $1 trillion to their members on preferential terms and without the austerity and pro-cyclical conditionalities typically imposed by the IMF. They also offered an economic "voice" that was absent in the Bretton Woods institutions who have still not altered voting rights to reflect the new economic weight of developing country members. Nonetheless, they remain small in comparison to a new, third source of finance in the form of bilateral swaps, as shown in figure 6.1.

Table 6.1 Major regional financial arrangements within the global financial safety net

Regional financial arrangements (RFA)	Year of inception	Members
Arab Monetary Fund (AMF)	Founded in 1976 by the Economic Council of the League of Arab States	Algeria, Bahrain, Comoros, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, State of Palestine, Qatar, Saudi Arabia, Somalia, Sudan, Syrian Arab Republic, Tunisia, Yemen
BRICS Contingency Reserve Arrangement (CRA)	Founded in 2015 by the country grouping known as BRICS	Brazil, Russian Federation, India, China and South Africa
Latin American Reserve Fund/Fondo Latinoamericano de Reservas (FLAR)	Established in 1978 as Andean Reserve Fund (FAR), transformed into FLAR in 1991	Plurinational State of Bolivia (1988), Colombia (1988), Costa Rica (1999), Ecuador (1988), Paraguay (2015), Peru (1988), Uruguay (2008), Bolivarian Republic of Venezuela (1988)
Chiang Mai Initiative Multilateralization (CMIM)	CMIM was signed in December 2009 as successor to the Chiang Mai Initiative (CMI) founded in 2001	Members of the Association of Southeast Asian Nations (ASEAN) plus three partner countries: China, Republic of Korea and Japan
Eurasian Fund for Stabilization and Development (EFSD)	2009	Armenia, Belarus, Kazakhstan, Kyrgyzstan, Russian Federation and Tajikistan
European Stability Mechanism (ESM)	2012, successor to European Financial Stability Facility established in 2010	Austria, Belgium, Cyprus, Estonia, Germany, Finland, France, Greece, Ireland, Luxembourg, Malta, Portugal, Slovakia, Slovenia, Spain, Netherlands
South Asian Association for Regional Cooperation (SAARC)	1985	Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka

Source: UNCTAD secretariat based on Mühlich and Fritz (2021, 2022); RFA websites and reports.

Figure 6.1 Evolution of the global financial safety net, 1994–2018 *(current dollars)*



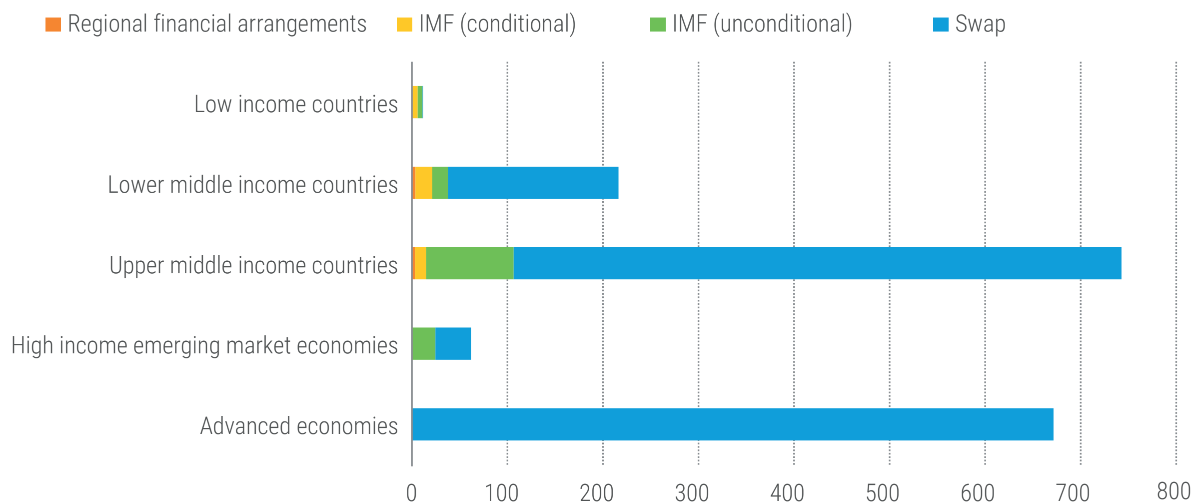
Source: Mühlich et al. (2020).
Note: AMF – Arab Monetary Fund; CMI(M) – Chiang Mai Initiative (Multilateralization); CRA – Contingent Reserve Arrangement of the New Development Bank; EFSM – European Financial Stabilization Mechanism; EFSD – Eurasian Fund for Stabilization and Development; ESM – European Stability Mechanism; EU BOP – EU Balance of Payments Assistance; EU MFA – EU Macro Financial Assistance; FLAR: Latin American Reserve Fund (according to its Spanish acronym); SAARC – South Asian Association for Regional Cooperation Swap Arrangement; NAFA – North American Framework Agreement.

1. Counter-cyclical and counter-intuitive? Covid-19 and the untapped liquidity of RFAs

Despite the expanded capacity of the RFAs, they remained largely untapped during the recent Covid-19 period, with IMF facilities and bilateral swaps used more extensively. This is a change from previous crises, when many developing countries turned in the first instance to their regional financial institutions. This time around, the RFAs lent out more than $5 billion to their members; however, this was much less than their capacity. Further, it was dwarfed by bilateral currency swaps between central banks, standing at more than $1.5 trillion and IMF lending of $119 billion (figures 6.2 and 6.3). The RFAs between emerging and developing economies have been used very unevenly and at a relatively small scale (AMF: 10 programs with a total volume of about $1358 million; EFSD: three programs, $650 million; SAARC: 5 programs, $1200 million; FLAR: one program, $308 million) or have not been used at all (CMIM and CRA). The total loan amount approved for RFAs requested by such countries amounted to $3.5 billion.

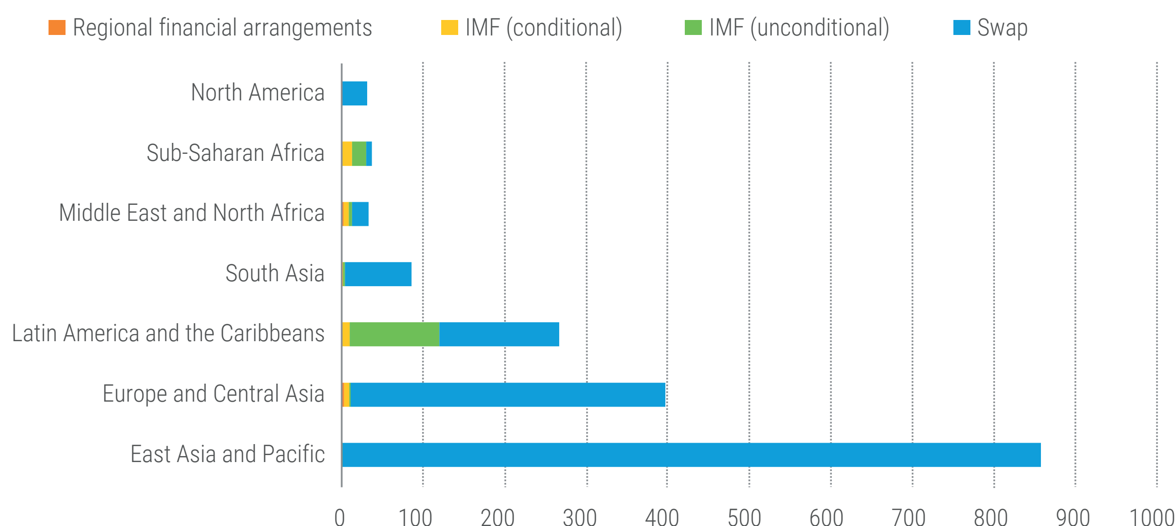
This pattern is evident for both the lower-income countries and the higher-income ones (Hawkins and Prates, 2021; Mühlich and Fritz, 2021, 2022; Mühlich et al., 2020, 2022). This trend of heavy reliance on bilateral swaps was already observed in the year before the Covid-19 crisis and was causing concerns (Mühlich and Fritz, 2022; Barrowclough et al., 2022). The experience of the last three years has only magnified those concerns.

Figure 6.2 Active central bank currency swaps and lending from IMF and regional financial arrangements, selected income groups, March 2020–December 2021 *(billions of dollars)*



Source: UNCTAD secretariat calculations based on Mühlich et al. (2022) and UNCTAD/Boston University Global Financial Safety Net tracker.
Note: Data refer to accumulated amounts by country groups. Country group classification follows IMF (2021, October) World Economic Outlook and World Bank criteria. In particular, "high income emerging market economies" relate to high-income countries that are not considered advanced economies by the IMF. Because of the primary reserve currency status of the dollar in the global economy, data for the United States were not considered in this figure. Based on an assumption of reciprocity, swaps between advanced economies are counted twice, while those between advanced economies and emerging market and developing economies (EMDEs), only appear on the EMDE side. Also, swaps between the People's Bank of China (PBOC) and other EMDEs are only reported for PBOC partners. The volume of unlimited swap agreements is based on the maximum amount activated during the analysed period while limited swaps correspond to the total amount made available per country between March 2020 and December 2021. IMF conditional instruments include stand-by arrangements (SBA), catastrophe containment and relief (CCR), extended fund facility (EFF), while non-conditional instruments include rapid credit facility (RCF), rapid financing instrument (RFI), flexible credit line (FCL), precautionary and liquidity line (PLL), short-term liquidity (SLL). IMF lending corresponds to the sum of IMF loans agreed between March 2020 and October 2021. Lending relating to regional financial arrangements (RFAs) corresponds to the sum of loans by all RFAs agreed between March 2020 and December 2021.

Figure 6.3 Active central bank currency swaps and lending from IMF and regional financial arrangements, selected geographic areas, March 2020–December 2021 *(billions of dollars)*



Source: See figure 6.2.
Note: See figure 6.2.

An obvious question is why countries who are members of RFAs would not turn more to their use, given their apparent benefits. Another paradox is that while the RFAs with the largest lending capacity were not used at all, RFAs with the smallest and mid-sized lending capacity were the most used. Analysis of members of a variety of RFAs comparing their pre-Covid-19 borrowing patterns with Covid-19 borrowing found RFAs tended to be used more when the funds had an autonomous institutional setup (i.e. with lending not contingent on an IMF package) and a balanced decision making and governance structure, whereby member country voting rights and borrowing were not solely dependent on their capacity to contribute capital. Whereas the small, autonomous and relatively egalitarian regional funds, such as the AMF and the FLAR, were repeatedly in demand from their member countries, even if at lower intensity than during the prepandemic period, the more unevenly organized but relatively voluminous regional funds, such as the EFSD or the SAARC swap agreement, were less used as standalone crisis finance providers. Furthermore, nonautonomous voluminous regional funds, such as the CMIM or the CRA, were not in use at all (Mühlich and Fritz, 2022).

Another factor contributing to the trend is that the IMF offered more lending without conditionalities. From the beginning of the spread of the Covid-19 related economic fallout until the end of December 2021, the IMF disbursed about $137 billion (80 per cent) of overall lending as unconditional lending. Nonetheless, in total, the IMF provided less than a fifth of its available lending capacity of $1 trillion, and the bulk of financing went through a very small number of countries that had previously prequalified for unconditional IMF lending.

At the same time, however, swap arrangements were offered by a wide range of central banks, including some from developing countries, such as the central banks of India, Maldives, Sri Lanka, Bhutan, Qatar and Indonesia, to name a few. They are, of course, dwarfed by swaps arranged by the United States Federal Reserve (Fed) and the People's Bank of China (PBOC) and to a smaller degree by other advanced economies' central banks, such as Japan, the United Kingdom, Australia, Sweden and Switzerland. These may be smaller but they represent an important source of finance to their users.

This new formation of the GFSN is raising concerns, however, because while these seem to be a voluminous source of finance, in practice, such bilateral swaps lack many of the advantages of multilateral global or regional lending – including its predictability and transparency. This aspect of the GFSN is discretionary and not driven by standard practices or protocols; it is therefore not a level playing field, given that not all countries have the ability to negotiate such bilateral agreements and the relationship between lender and borrower is not necessarily equal, depending on the interests of the creditor country, especially with respect to trade and financial ties, but also with respect to political and geostrategic issues. In practice, this form of liquidity provision during Covid-19 was strongly skewed towards higher income countries (figure 6.2) and to certain regions (figure 6.3) in East and Central Asia and Europe.

2. Implications for the RFAs

There have long been concerns about the inequities and inefficiencies of the GFSN, with so-called knots and gaps persisting even as the emergence of new institutions and mechanisms has given developing countries wider options. It was not, however, ever a real concern that the regional multilaterals might become marginalized in favour of bilateral arrangements. Now, there are at least five major concerns:

I - If demand for liquidity grows – which seems likely given the continued post-Covid-19 environment of rising interest rates and spiraling food prices – poorer countries and regions less covered by the GFSN will struggle to find the required crisis financing.

II - The extent to which bilateral swaps have out-paced multilateral liquidity provision throughout the crisis raises questions about countries' confidence in these institutions' crisis resolution capacity.

III - Maintaining choice and competition in the system is important to encourage better service delivery and enhance the bargaining power of governments in programs to return nations to stability and sustainability and to ensure all countries have the support they can depend upon, not just a few. Regional financial arrangements provide an important "voice" for member countries not included in significant multilateral institutions. The G20 (Principle No. 5) urges the prevention of arbitrage and facility shopping, especially for policy conditions and pricing (G20, 2011); yet this is what many developing countries want and a partial reason for the establishment of their RFAs in the first place.

IV - The threat of potential marginalization of RFAs was evident before Covid-19, and some writers argued they should ensure their member countries had ownership of regional surveillance and enforcement systems, rather than giving it to outside institutions (Grimes, 2011). The reluctance to use the CMIM in the last decade, for example, was linked to the fact that lending was concomitant with agreement on an IMF program (Mühlich et al., 2022, p. 148). Nonetheless, the longstanding inequalities in access to and availability of short-term financing point to the lack of coordination in the existing GFSN.

V - Finally, a reduction in the use of regional multilateral institutions raises the spectre of national interests increasingly influencing the crisis finance regime. Swaps are an option only for a small minority of countries and maybe not those who most need support. This vast volume of bilateral liquidity is not the same as a global safety net.

3. Countering dollar hegemony

The persistence of United States dollar hegemony in a context of continued hyper-globalization, marked by open capital accounts, floating exchange rates and financial deregulation, has played an essential part in facilitating the emergence of an international monetary system that has favoured short-term financial and corporate interests over developmental ones in a systematic fashion (box 6.1). This has come at a high cost to developing countries in terms of the financing of reserve accumulation and the servicing of dollar denominated debt contracts (*TDR*, 2019).

This changes the stakes for developing countries in seeking at least a partial escape from dollar hegemony by strengthening regional monetary cooperation and marshalling their own financial firepower to ease the constraints imposed on their development prospects in today's debt-driven global economy. This, it should be noted, is not about longer-term South-South cooperation to prop up development finance through large-scale lending programs, much as these are both necessary and welcome in view of hesitant, limited and often unpredictable development financing initiatives from developed countries. Rather, regional monetary cooperation among developing countries can complement and support longer-term South-South financial cooperation, if it substantially increases the ability of developing regions to refinance and promote intraregional trade and develop intraregional value chains (see Chapter V).

The scope and effectiveness of regional monetary arrangements depend on agreed-upon objectives. These range from simple regional reserve swap and pooling agreements to bridge liquidity constraints when these arise, to the full-scale development of regional payment systems and internal clearing unions. The latter extend credit to members through the regular offsetting of accumulated (trade-related) debts and credits between them and thus at least partially replace reliance on external foreign-denominated financial resource and associated exchange-rate volatility with local financial resources. This requires the use of a non-tradable regional unit of account, much like the international accounting currency proposed by Keynes to manage the international monetary system, that promotes intraregional trade by allowing accumulated credits within the regional clearing mechanism to be offset against debits only through imports from, or foreign direct investment in, member states at fixed intraregional exchange rates against the regional unit of account (Kregel, 2018).

The scope for deeper monetary integration in the form of payment systems and clearing mechanisms largely depends on the initial trading patterns and positions of prospective member states, as the extent to which intraregional credit creation and clearing can be used to substitute for external financial resources depends on countries' ability to extend credit. The higher the share of intraregional trade, the greater the scope for intraregional monetary arrangements to help expand this. But the net commercial trade balances within country groupings also matter, as the idea of a regional clearing union is precisely to use the extension of trade credits to participant deficit countries to replace covering trade imbalances by compensating external capital inflows.

The purpose of such clearing arrangements is, of course, also to increase intraregional relative to extraregional trade, such that current trade patterns change. This, in turn, requires political will. For regional clearing unions to function properly in the interest of freeing up the regions' own financial resources and policy space to pursue national development strategies, regional interests have to be prioritized. Sometimes, even over immediate national interests, in the understanding that reverse priorities will ultimately undermine both collective and national developmental goals. (See Barrowclough et al., 2022 for a review of different countries' experiences of these mechanisms and institutions.)

Box 6.1 The Persistence of the US Dollar as an International Currency

The one continuous feature of the international economic system that emerged from the wreckage of the Second World War has been the central role of the dollar as the premier vehicle currency in the private sector and the premier reserve currency in the official sector.

Over the past few decades, however, financialization has evolved at an accelerated pace; the financial sector now dominates the real productive economic sector on which it rests. In 1980, the combined nominal value of the world's equity and bond stocks stood at about $11 trillion, a figure on a par with that for nominal world GDP in that year. By 2020, the combined value of those securities stocks had grown over 20-fold to $234 trillion, while world GDP only registered an eight-fold increase to $84 trillion (SIFMA, 2021). This divergence between financial and productive assets is fuelling a narrative, if not of an impending collapse of the dollar-based international financial system, then of its growing fragmentation (for an in-depth debate, see Lysandrou and Nesvetailova, 2022; Galbraith, 2022).

Between 1986 and 2019, daily forex turnover rose from about $0.4 trillion to $6.6 trillion (BIS, 2019). During this period, the dollar's share of this turnover averaged about 44 per cent. In today's terms, this percentage is roughly on a par with the United States respective percentage contributions to the world's equity stocks (40 per cent of the $95 trillion outstanding in 2019) and the world's bond stocks (39 per cent of the $106 trillion outstanding in 2019; SIFMA, 2020). However, it is also far above the United States percentage share of nominal world output (23 per cent of the 2019 world gross domestic product (GDP) figure of $88 trillion). These numbers, taken in combination with the trend increase in the United States trade deficits, underpin the widely held view that there will soon come a time when foreign investors will lose confidence in the dollar and thus abandon it in the face of mounting concerns about the ability of the United States to meet its financial obligations in the face of its deteriorating macroeconomic fundamentals and recurrent financial shocks.

But financializaton is not a one-dimensional force. Its depth is just as important an indicator of its historical significance as its speed of development, because it reflects the structural role of finance in economic

transformation. To be specific, the recent scale of growth of the world's equity and debt securities markets is an outcome of fundamental changes in both their supply and demand sides.

From the supply side, there has been a growing dependence of both corporate entities and governments on security issuance, in tandem with the increasing size and complexity of modern economies. In this respect at least, what the United States offers, beyond possible alternatives, is a huge and varied abundance of securities (not only equities but also bonds, including corporate, financial, Treasury, agency and municipal bonds) in which foreign investors can store large amounts of funds. Given the need for dollars as a means of accessing the United States securities markets, it follows that while the sheer depth and liquidity of these markets attract foreign institutional investors in droves, this attraction serves, in turn, to further amplify the depth and liquidity of the market for dollars. This development helps to explain why the dollar remains the most widely used currency in the execution of various cross-currency transactions. Moreover, the depth and liquidity of the dollar market mean that even when those institutional investors holding globally diversified portfolios transfer funds from one set of non-dollar securities to another non-dollar set of securities, they usually do so indirectly, via the dollar, to contain the costs of these fund transfers.

The same persistence holds for predictions about the dollar's primacy as a reserve currency. The share of dollars in globally identified foreign exchange reserves has dropped over the last two decades by around ten percentage points from around 70 per cent in 2000. However, the drop occurred in the first few years following the introduction of the euro and has remained stable since then (*TDR*, 2019). The fundamental reason why the dollar has maintained this 60 per cent share of foreign exchange reserves even as these continue to grow exponentially in absolute terms comes down to the large mass of United States Treasuries. In today's era, when the world's capital markets are deep and highly integrated and cross-currency capital movements accordingly combine huge scale with high mobility, central banks who want to minimize the impact of these movements on their domestic currencies need to have in reserve financial securities that: (i) have a large and safe value storage capacity, (ii) are available in abundance, and thus (iii) are highly liquid. No other financial securities and no other financial instruments, including crypto and digital currencies, can match United States Treasuries in these criteria.

Thus, as with institutionally managed asset portfolios, foreign exchange reserve portfolios are organized according to a hierarchical structure, with the core segment typically comprising United States Treasuries and satellite segments comprising higher-yielding securities of other governments.

If any EME-based central banks needed any reminder of this crucial fact, the events of early March 2020 provided it. By that time, the Covid-19 pandemic's negative impact on the global economy was clear to the world's institutional investors, and they quickly withdrew funds amounting to over $100 billion from the EMEs in the space of days. That withdrawal was catastrophic for many countries, but the impact would have been even more devastating had their central banks not quickly intervened in their domestic currency markets with huge sales of the United States Treasuries kept in their reserves.

On 1 April 2022, the Bank for International Settlements (BIS) launched its Thirteenth Triennial Central Bank Survey of Foreign Exchange Transactions and Over-the-Counter (OTC) Derivatives Markets, the full results of which are due to be published in November 2022. In the two full years between the 2019 survey and the current one, the world economy suffered its biggest shock since the Great Depression of

the 1930s with the outbreak of the Covid-19 pandemic. In 2020, nominal world GDP fell from its 2019 figure of $87.4 trillion to $84.9 trillion, while the world's combined bond and equity stocks increased by more than 15 per cent from $200.9 trillion in 2019 to $234.3 trillion, an increase principally driven by the steep increase in government bond issuance on the one hand, and the increase in security prices fuelled by monetary policy easing, on the other. In 2021, economic recovery saw nominal world GDP rise above its prepandemic level to $94.9 trillion, but the world's combined equity and bond stocks also rose substantially, to reach over $241 trillion (SIFMA, 2022).

In both these Covid-19-impacted years, the United States share of the world's supplies of equities and bonds remained stable at around 40 per cent. Thus, going by the observation that forex turnover volume is overwhelmingly driven by financial sector interests as distinct from those of the real sector, the dollar's share of the new 2022 figure for daily forex turnover will remain largely unchanged.

Source: Derived from Lysandrou P and A Nesvetailova (2022) "Why the Ukraine crisis will make little difference to dollar supremacy", *Institute for New Economic Thinking*, 24 June 2022, https://www.ineteconomics.org/perspectives/blog/why-the-ukraine-crisis-will-make-little-difference-to-dollar-supremacy.

C. LONG-TERM FINANCE: NEW ROLES FOR REGIONAL AND MULTILATERAL DEVELOPMENT BANKS

More than 90 per cent of development banks across the world are either national or subnational (Xu et al., 2019). While few in number, however, the multilateral and especially regional multilateral DFIs have a particularly important role to play. Regional banks – meaning banks with multiple owners, usually governments from the same region – are an integral part of the global financial infrastructure and the development system. They play the important role of linking national development banks with the international financial system and in some cases they help by coordinating multiple governments and multiple banks across projects greater than any can do alone. For some countries and projects, they may be the most important source of long-term and reliable finance, whether it be for financing and promoting trade (the main priority for many higher-income countries) or for financing infrastructure, agriculture and development in general (the goal of middle-income and lower-income countries' banks) (Xu et al., 2019, p. xi). They are needed now, more than ever, given the rise of challenges that go beyond national borders – like responding to climate change or to global shocks such as the recent experience of Covid-19. Table 6.2 shows how these important regional, inter-regional and global multilateral banks have emerged in a series of waves over the decades since the establishment of the World Bank in 1944.

Table 6.2 Evolution of the multilateral development bank landscape, 1944-present

Establishment year	Bank Name	Geographical scope	Total Assets in 2020 *(billions of dollars)*
WWII-1960s – Bretton Woods and the global view			
1944	World Bank	Global	536.6
1956	International Finance Corporation	Global	105.3
First regional development banks – regional integration and development			
1956	Council of Europe Development bank	Europe	34.2
1958	European Investment Bank	Europe	766.8
1959	Inter-American Development Bank	LAC	147.5
1960	Banco Centroamericano de Integracion Economica	LAC	13.3
1963	International Bank for Economic Cooperation	Asia Pacific	1.0
1964	African Development Bank	Africa	50.9
1966	Asia Development Bank	Asia Pacific	271.7
1967	East African Development Bank	Africa	0.4
1970	International Investment Bank	Inter-Regional	2.0
1970	Banco de Desarrollo de América Latina	LAC	46.8
1970	Caribbean Development Bank	LAC	2.1
1973	Banque de Developpement des Etats de l'Afrique de l'Ouest	Africa	6.0
1973	Arab Bank for the Economic Development of Africa	MENA	5.5
1974	Fondo Financiero para el Desarrollo de la Cuenca del Plata	LAC	1.7
1974	Arab Fund for Social and Economic Development	MENA	12.9
1975	Nordic Investment Bank	Europe	43.3
1975	Banque de Développement des Etats d'Afrique Centrale	Africa	1.2
1975	Ecowas bank for Investment and Development	Africa	1.0
1976	OPEC Fund for International Development	MENA	5.9
1977	International fund for Agricultural Development	Inter-regional	9.6
1985	Trade and Development Bank	Africa	7.2
1989	Arab Trade Financing Programme	MENA	1.2
1989	Pacific Islands Development Bank	Asia Pacific	0.0
1989	Nordic Development Fund	Europe	0.9
1990s–2000s – Regionalism and market-led development, global vertical funds, trust funds hosted by multilateral development banks			
1991	European Bank for Reconstruction and Development	Inter-regional	85.3
1993	African Export and Import Bank	Africa	19.3
1993	Interstate Bank	Asia Pacific	0.2
1993	North American Development bank	LAC	2.2
1999	Islamic Co-op for the Development of the Private Sector	Inter-regional	3.3
1999	Black Sea Trade and Development bank	Europe	3.4
2005	Economic Coop. Organization Trade and Development	Asia Pacific	0.7
2006	Eurasian Development bank	Asia Pacific	5.6
2010 onwards – Regionalism and the rise of the South, the return of industrial policy			
2014	New Development Bank	Inter-regional	18.8
2015	Banque Maghrébine d'investissement et de Commerce Extérieur	MENA	n.a.
2016	Asian Infrastructure Investment Bank	Asia Pacific	32.1

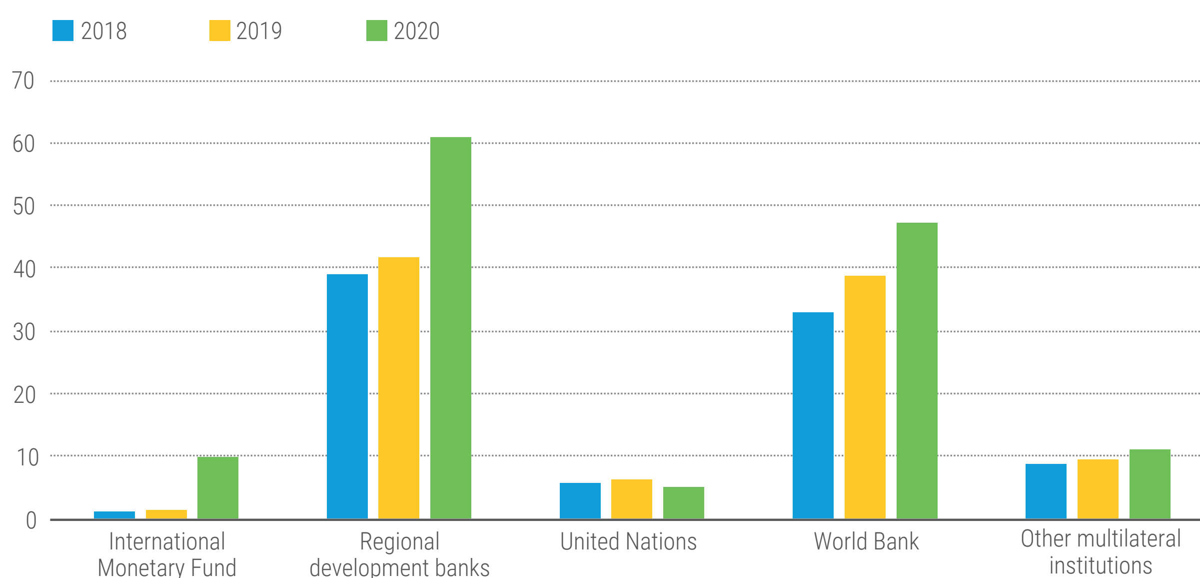
Source: Update of Ocampo and Ortega (2020) using the July 2022 version of the Public Development Banks and Development Financing Institutions database provided by Xu et al. (2021).

1. The new landscape of long-term regional finance

Regional sources of development finance have been increasing significantly in the last decade – from the creation of new regional DFIs to the scaling up of existing ones and new trends where some national banks lend to their region or even beyond. Some of these changes have been particularly marked in the South.

This matters because regional banks are an important source of long-term finance – and for some regions, one of the most important. As shown below, loans committed by regional banks have increased steadily over decades, sometimes growing faster than Bretton Woods lenders and exceeding total disbursements as well (figure 6.4). According to OECD Development Assistance Committee (DAC) statistics, they provided at least $180 billion in aggregate in 2018, more than double the funds the banks initially received from their owner governments, reflecting that banks leverage their capital by borrowing on international financial markets in addition to receiving revenues from loans and profits from investments. When other banks that are not officially defined as regional multilateral development banks (MDBs) are included, such as the European Investment Bank (EIB) or Asian Infrastructure Investment Bank (AIIB), this rises to over $300 billion (Ocampo and Ortega, 2020).

Figure 6.4 Multilateral disbursements to developing countries by institution, 2018–2020
(billions of constant 2020 dollars)

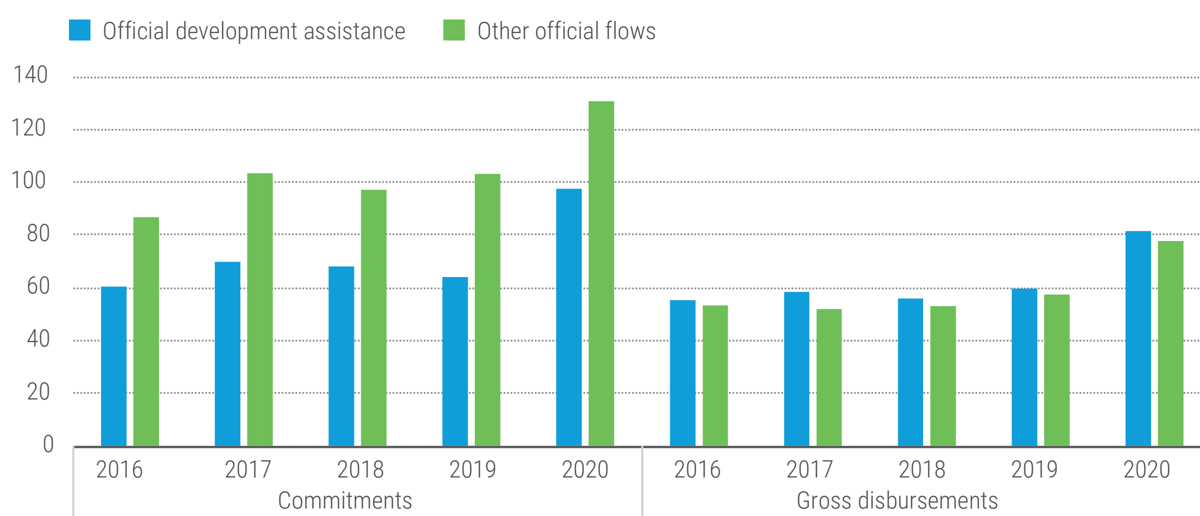


Source: UNCTAD secretariat calculations based on OECD Creditor Reporting System.
Note: Disbursements consider official development assistance (ODA) and other official flows (OOF), both following OECD definitions. Regional development banks include: AfDB, ADB, IADB, AIIB, CABEI, CarDB, CEDB, EBRD, and IsDB. Other multilateral institutions include: Adaptation Fund, Arab Bank for Economic Development in Africa (BADEA), Arab Fund (AFESD), Black Sea Trade and Development Bank (BSTDB), Center of Excellence in Finance (CEF), Central Emergency Response Fund (CERD), Climate Investment Funds (CIF), Eurasian Fund for Stabilization and Development (EFSD), Global Alliance for Vaccines and Immunization (GAVI), Global Enviromental Facility (GEF), Global Fund, Global Green Growth Institute (GGGI), Green Climate Fund (GCF), Montreal Protocol, Nordic Development Fund (NDF), OPEC Fund for International Development (OPEC Fund), OSCE, UNCTAD, and the WTO International Trade Center.

Most importantly, slightly more than half the official lending was concessional (OECD, 2020b, p. 23) with respect to the interest rate charged to borrowers, maturity or other characteristics compared to commercial lenders or grant-based lending (figure 6.5). This feature is important because the kind of lending that is typically the province of public development banks, namely infrastructure or social investments with high capital costs upfront and very long-term revenue prospects, is eschewed or under-provided by commercial lenders.

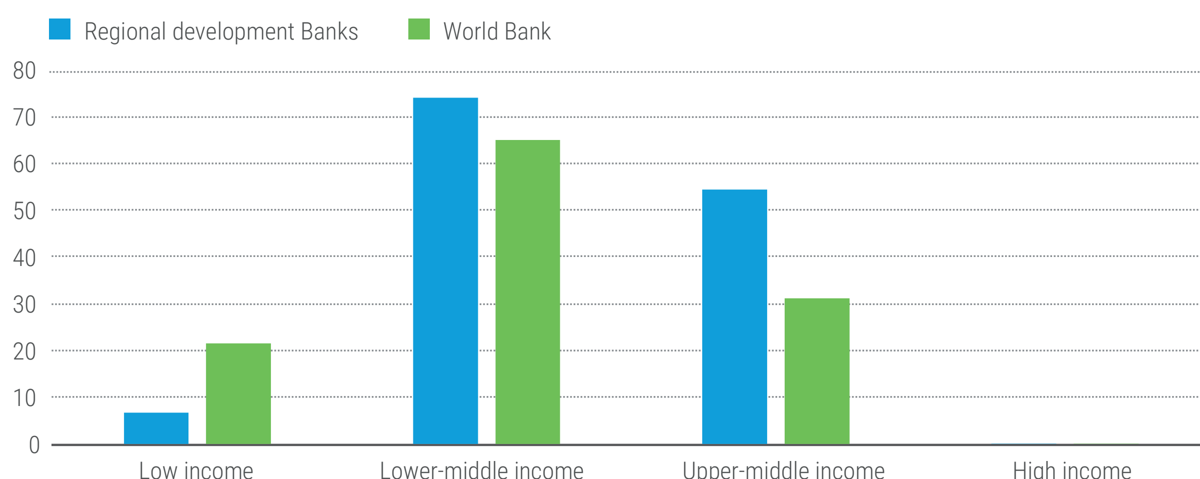
Not all regions are equally well served, and as shown in figure 6.6, there can be a big variation between individual banks, countries and regions. In Sub-Saharan Africa, lending by the MDBs is estimated to account for as much as 10 per cent of GDP, divided roughly half and half between the World Bank Group and regional banks. For South Asia, Latin America, the Caribbean and Europe, lending from MDBs is just over 4 per cent of GDP, indicating the availability of other sources of finance from national banks and commercial sources (Ocampo and Ortega, 2020). North Africa and Oceania are particularly poorly served. The evidence shows that both the World Bank and regional development banks disburse less to lower income countries than they do to middle income countries overall, presenting the challenge to scale up development finance to the poorest countries across the globe.

Figure 6.5 Commitments and disbursements of international financial institutions to developing countries by lending type, 2016–2020 *(billions of constant 2020 dollars)*



Source: See figure 6.4.
Note: See figure 6.4. International financial institutions include the regional development banks of figure 6.4, together with IIB, IMF and World Bank.

Figure 6.6 Disbursements by regional development banks and World Bank to developing countries by income group, 2018–2020 *(billions of constant 2020 dollars)*

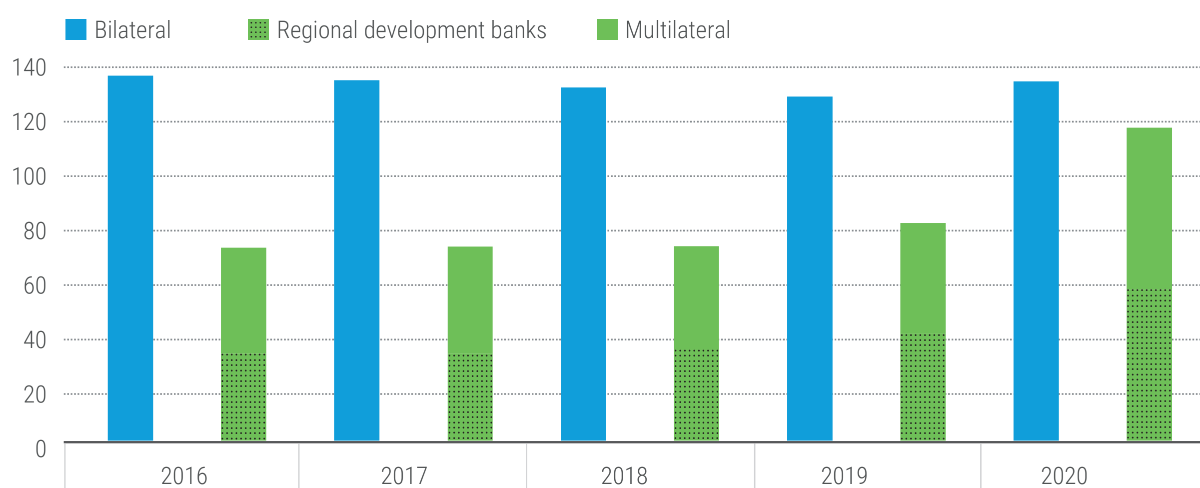


Source: See figure 6.4
Note: See figure 6.4. Income groups follow the World Bank classification.

A third reason the regional MDBs are important is that some of their new firepower is coming from the South, with Southern-owned and led banks offering an alternative to the traditional sources of finance and a fresh "voice" in international debate more commensurate with their economic weight. The national development banks lending outside their national borders and into the region and beyond are also often Southern-owned (*TDR*, 2015; UNCTAD, 2018a, b; Gottschalk and Poon, 2020; Barrowclough et al., 2020; UNCTAD, 2018b). This is not captured in the official DAC statistics but is changing the landscape significantly, enabling choices that did not exist before (Grabel, 2018).

These trends notwithstanding, it is remarkable to see the rise of non-multilateral, ad hoc bilateral flows and "ear-marked" donor funding. As the richer countries of the North have mostly not significantly increased financing for the regional development banks (RDBs) in which they have a stake, new sources of finance are filling the void. As shown in figure 6.7 and echoing the story of liquidity finance told in Section B, the regional multilateral sources represent less than half of the value of bilateral flows in the latest year for which data are available – even though this includes one of the biggest years for RDBs in a long time.

Figure 6.7 Bilateral and multilateral disbursements to developing countries, 2016–2020
(billions of constant 2020 dollars)



Source: See figure 6.4
Note: See figures 6.4 and 6.5. Bilateral disbursements consider only DAC countries. The dotted area represents the contribution of regional development banks in multilateral disbursements.

VI

2. The role of RDBs during crisis: counter-cyclical responses during Covid-19.

Many regional development banks played a strong counter-cyclical role during Covid-19, either increasing their lending significantly compared to other years or redirecting lending to other uses for their members or yet again, being the main sources of lending in the absence of other finance from national lenders (in the case of the lower-income countries) or from global financial providers (in the case of the middle-income developing ones) (Griffith-Jones et al., 2022 forthcoming). Many geared up quickly, as shown in table 6.3. Some also lent outside their immediate regions, in the search for new clients, as few governments were able to begin new infrastructure projects during this difficult time (box 6.2).

Table 6.3 Loan commitments and disbursements by selected regional development banks, 2019–2020 *(billions of dollars)*

	Loan commitments			Loan disbursements		
Regional Development Bank	2019	2020	Percentage change	2019	2020	Percentage change
European Investment Bank	65.8	108.8	65	53.8	66.4	23
Asian Development Bank	24.0	31.6	32	16.5	23.6	43
Development Bank of Latin America (CAF)	13.0	14.1	9	10.0	10.4	3
Inter-American Development Bank	11.3	12.6	10	10.9	14.9	38
New Development Bank	7.2	10.3	43	0.9	5.4	488
Asian Infrastructure Investment Bank	4.5	10.0	120	1.5	6.2	321
Islamic Development Bank	7.8	6.8	-13	8.2	7.0	-15
African Development Bank	10.0	5.8	-42	5.3	7.2	36
Trade and Development Bank (formerly the PTA Bank)	5.1	5.5	7	n.a.	n.a.	n.a.
Banque Ouest Africaine de Développement (BOAD)	0.9	1.2	36	0.7	0.9	32

Source: Griffith-Jones et al. (2022 forthcoming).

Box 6.2 What does regionalism mean to the new Southern-led banks?

The membership of the new Southern-led banks may be as much about shared and common development goals, challenges and capacities as about close proximity in terms of geography. Physical location is still important for many of the institutions established in earlier decades but less so for the most recent ones, born in an age when communications and travel are easy. Even the AIIB – which by name is rooted in Asia – has both borrowers and lenders that are far from Asian borders.

Similarly, the NDB was never meant to be just concentrated on the original BRICS founding members (Brazil, Russian Federation, India, China, South Africa) and has always had a global vision, albeit focused on developing and emerging economies. From the outset, it was interregional rather than narrowly regional, as its founding members in 2015 came from countries in all corners of the world. With an initial capitalization of $50 billion in paid in and callable capital and subscribed capital of $100 billion, the bank aims to be a powerful resource for its Southern borrowers around the globe. New members were added last year, again broadening the interregional flavour – Bangladesh, Egypt, the United Arab Emirates (UAE) and Uruguay – and another five to ten members will be added next year.

Taking on new members will inevitably dilute the ownership of the original founders and potentially change the direction of lending, an issue for any bank considering increasing its capitalization by taking on new

members. However, in the NDB's case the founders' share is retained at 55 per cent of the total, with another 25 per cent to be owned by other emerging countries and the final 20 per cent to be held by governments from advanced economies. The fact the founders managed to attract new funds and yet retain the dominant vote is seen as reflecting the rise in influence commensurate with economic weight of some of the larger members. It suggests the NDB can increase capitalization significantly, thereby raising the bank's firepower for lending, without changing its intrinsic nature because the initial founders will retain voting predominance. Similarly, in the AIIB, with its very large number of shareholders drawn from the entire world, China retains the veto right on voting.

Both new banks have the ambition to focus on green lending, which could be relatively easier for them than for older banks with long histories of supporting activities that are now considered problematic, but which were not decades ago. The NDB, for example, has no lending to coal. Moreover, despite having advanced country members, both banks aim to lend to emerging markets, being quick and agile with lending and following the environmental standards of borrower countries, not those of more advanced countries. At the same time, these banks have many partnerships with other banks, including the World Bank, and this is needed for technical capacity and expertise. NDB officials say the bank learned a great deal from its partnerships with the legacy and other multilateral banks, with whom it did many co-financings during Covid-19 relief and recovery programs. While the NDB aimed to be different from, and complementary to, the World Bank, it is still one of its key partners. Hence, regionalism does not bring competition but distinctiveness.

From the borrowers' perspective, the benefits of membership in specialized Southern-oriented DFIs were evident during the Covid-19 crisis. The NBD moved extremely quickly and was the first institution to lend to members South Africa and India when their economies were struck by Covid-19. Perhaps because the pandemic was first noted in a member country, when the pandemic ravaged the BRICS members, it was seen by the bank as the "central and most critical development challenge facing our countries." "When the building is on fire," said one senior official, "we don't discuss medium-term investment such as infrastructure."

The AIIB is also interregional and Southern-focused in its lending, although it has global owners, including many from the North. Before Covid-19, it limited its lending to the Asian region, and any lending outside Asia had to be somehow related to Asian investments, Asian markets or Asian development needs. This requirement was lifted only when the impact of lockdowns meant the bank had to seek alternative investments further afield. Much of this lending is still at the national level as cross-national projects are difficult to initiate, in part because they need to be supported by complementary regulations and other policies, and interests need to be balanced between the different countries involved. The AIIB has a goal for 25 per cent of its lending to be "cross border" by 2030, inspired by regional trade treaties, including the Regional Comprehensive Economic Partnership (RCEP), Trans-Pacific Partnership (TPP) and the Comprehensive and Progressive Agreement for a Trans-Pacific Partnership (CTTP), which are expected to have a transformative impact on the region and should make it easier for the bank to arrange interregional lending associated with trade, such as transforming transport, power grids and connectivity or trying to access the giant supply chains running across Asia.

Source: Derived from Griffith-Jones et al. (2022, forthcoming); UNCTAD interviews with senior bank officials, May and June 2022.

Box 6.3 Regional banks and projects: how a Multilateral Development Bank financed the anti-Covid-19 vaccine

Public development banks, it is often argued, provide more than just finance – they can also provide expertise and technical advice on how to design and manage difficult or complex projects. Both attributes are needed for the kinds of projects characterized by uncertainty, risk, the prospect of low or zero profits and the need for coordination among many parties – all of which are deterrents to attracting finance from commercial or private banks. This may be particularly so when benefits and costs are spread across multiple countries, as was the case with the health impacts of Covid-19. The following describes how the EIB helped to finance the research and development of an anti-Covid-19 vaccine.

On 11 June 2020, EIB and BioNTech, a German company, signed an agreement for a Venture Debt (VD) operation of €100 million debt financing for the development of a Covid-19 vaccine in partnership with the pharmaceutical company, Pfizer. The German company, which had already signed a VD agreement at the European level in December 2019 for cancer research, also agreed to increase its own manufacturing capacity for a faster distribution of the vaccine at its own risk. The loan was guaranteed by the European Commission and the EIB, and they equally shared the guarantee. Resources, distributed in two equal instalments, came from the European Fund for Strategic Investments (EFSI) and from the InnovFin Corporate Research Equity fund, part of the Horizon 2020 program, specifically from the Infection Diseases Finance Facility (IDFF), which had already invested more than €500 million in the Covid-19 vaccine. In December 2020, the Covid-19 vaccine developed by BioNTech and Pfizer was approved by the United Kingdom medicines regulatory authority, and a few days later, the vaccine began to be administrated in the country. A few weeks later, Canada, Mexico and the United States approved the vaccine, and the European Union followed suit, though slightly later. The vaccine was ultimately approved and used worldwide, including in developing and emerging economies.

Thus, the European regional development bank EIB contributed to the creation of an important global public good, as a response to the Covid-19 pandemic. The example is also important because of its central idea that development banks can be deployed in ways that maximize their development impact, and the use of the VD mechanism enables the bank to pursue sustainable and inclusive impacts while maintaining some financial profits or at least avoiding losses. It is a way of appropriate risk sharing as opposed to the so-called "de-risking" that usually means transferring risks from the private sector to the EIB and ultimately to its member governments and tax payers (see also Mazzucato and Mikheeva, 2020).

Source: More details available in Griffith-Jones S and Carreras M (2021) and European Investment Bank (2021).

D. SCALING UP CAPITALIZATION AND CAPACITIES: NEW SOURCES OF FINANCE FOR RDBs.

One way to redress the striking and growing disparity between multilateral lending versus ad hoc and bilateral capital flows would be to direct more funds to RDBs. One of the most obvious lessons to emerge from the Covid-19 experience of RDBs is the importance of having sufficient and reliable sources of capital. Unsurprisingly, those banks that were well capitalized were better able to provide assistance when needed (Griffith-Jones et al., 2022, forthcoming). Many national banks – often already under pressure before the shock of Covid-19 – relied on their regional DBs, so it makes an important difference when the RDB has some spare capacity to cope with the unexpected. These lessons are important given that future shocks are likely – whether climate related or financial – on top of the fact that RDBs face a far bigger role in the future in helping fund the investment needed to carry out the transition to low-carbon and more inclusive economies. Moreover, some policies now under consideration to address these challenges – such as carbon border taxes or other heightened environmental standards – will likely require additional financial investments in developing countries. If development banks are to be in a position to respond to such demand, they will need to be backed by higher levels of capital. This is especially important given the concern that CBAM and other mechanisms will likely hit revenue streams of developing countries much harder than those of more advanced or higher-income ones (for a discussion of this, see *TDR*, 2021, pp. 141–142). Recent research for UNCTAD's Least Developed Countries Report shows that trade imbalances and hence revenues would be worsened for LDCs, because they tend to be both import-dependent in "dirty" sectors and significant exporters of raw materials to those sectors (UNCTAD, 2022, chap. 2).

In advanced economies and in some (but certainly not all) middle-income countries (MICs), governments have the fiscal space to capitalize further their national development banks. Some did during the pandemic, such as the Uganda Development Bank, but, in fact, recapitalization was rare compared to the responses during the GFC. Moreover, it is often more difficult for the national governments of most low-income countries (LICs), many low-middle-income countries (LMICs) and even some MICs, which have limited fiscal space to respond to financial shocks or crises such as Covid-19 or to meet the challenges of the green and inclusive transition, to significantly capitalize their PDBs. In that case, it becomes desirable for the international community to step in and provide additional resources. As will be shown below, for many, this has taken the form of bilateral flows.There is a strong case that argues it is better – more transparent, more democratic and more equitable – to use the funds to help governments capitalize these national PDBs. Thus, providing them with additional credits, guarantees or help capitalize and provide additional finance to their RDBs so they can do the on-lending.

There are different ways this can be done, many of which have been discussed in previous Reports, such as taking on additional members, including from higher-income countries, as this both increases the pool of capital available and makes it easier for the banks to raise additional capital on international markets. Another would be to revisit the triple-A requirements imposed on most banks by their government owners, as this would enable them to hold smaller cash reserves. Still another is not to take on new members but rather to increase the capital contribution from existing government members. These are all important measures. The focus in the following section is on the most topical and current debate about the potential transfer of IMF special drawing rights (SDRs), including from those originating from a potential redistribution of the $650 billion SDRs already issued in 2021. This redistribution from advanced countries that do not need SDRs to poorer economies that need them was discussed as a principle supported by the G20. A tentative figure of $100 billion was approved for such a redistribution. The significance of this would be huge, as it is already more than the entire concessional lending by MDBs in 2018.

1. Recycling unused SDRs through RDBs

As Plant (2022) has pointed out, sharing access to global reserves could be an important component of the response to any crisis, especially as the only truly global financial response to the Covid-19 crisis was precisely the issuance of SDRs discussed above. This is different from the GFC, when there were important increases in the capital of MDBs and RDBs, facilitating strong increases of their lending commitments (see, for example, Griffith-Jones and Gottschalk, 2012).

The reallocation of these SDRs, to be channelled via RDBs and MDBs, so they can increase their capital and use it to harness their advantage of having knowledge of local borrowers' capacities and needs, is already technically possible. Some financial institutions possess the prescribed "holder status" for SDRs, and this includes the main RDBs and MDBs. Holder status could be broadened in future to other institutions, if the international community so wished, but for the moment, these institutions seem the best suited for this role.

MDBs and RDBs are natural candidates for SDR rechannelling because they match the policy objectives underlying the SDR general allocation with the existing public bank mandates, tools and experience. Their mission is to support development and to supply global public goods and they can do so because of their long-term financing and their ability to achieve maturity transformations across a wide range of schedules. They can also take the long view when it comes to financing the goods and services countries need in a way that other sources of finance cannot or will not do. MDBs and RDBs can create and guide capital, borrowing on capital markets and lending resources at affordable or concessional rates to their borrowing members, and these functions are closely compatible with the SDR mechanism. Most of the main RDBs and MDBs, in fact, are already prescribed holders of SDRs and can therefore use or borrow SDRs. In addition, the RDBs are often requested to increase their financial support in crisis times. And there has been somewhat of a signal to do so: in a virtual meeting on 15 April 2020, G20 Finance Ministers and Central Bank Governors called on the World Bank and RDBs to swiftly implement the response package previously adopted by their respective Boards but without increasing their capitalization, hence raising the question of how to do it.

In recent years, RDBs and MDBs have been increasingly active in the fight against climate change, on top of other important policy priorities; thus, they have no shortage of uses for which to direct the additional lending. Indeed, these MDBs and RDBs are a key but underused pillar of the international development finance architecture aiming at financing both mitigation and adaption to climate change projects, so they have a major role to play in contributing to reaching global goals such as the ones enshrined in the 2015 Paris Agreement.[1]

As banks, they already have the ability to leverage their capital and experience, whether through co-financing ventures with the private sector or with other public co-financiers. According to the African Development Bank (AfDB), MDBs can leverage SDRs by a factor of 3 to 4 by co-financing with private and public actors; this would multiply the positive effect on borrowing countries considerably[2] and help them meet the financing needs of national development banks in their member countries. The Joint MDB Report on Climate Finance (2020) further reported that for every dollar MDBs invested, an additional $0.29 came as co-financing from private sources, while some banks (AfDB and AIIB) reported another $3 from public sources, again indicating the potential advantages of augmenting the finance available to these banks (AfDB et al., 2020).

They also have the technical expertise to guide and manage the funds once created, benefitting from their close relationships with governments and experts in Ministries around the world. During the Covid-19 period, many RDBs were in regular contact with representatives of their government owners, helping to chart the path to relief and recovery. In this context, they can act as intermediaries between

[1] Reflecting this, most MDBs and RDBs announced that they would align all operations on the Paris Agreement, but there is a need for continued clarity on and evaluation of how to do this (*TDR*, 2021, pp. 151–154).

[2] AfDB presentation at a French Treasury/CGD event, Exploiting the Full Power of SDRs, Paris, 2 February 2022.

the global financial system and countries in need, especially countries with difficult and particularly expensive access to private capital markets. This includes both LICs and many MICs urgently requiring increased long-term funding to finance investment essential for recovery as well as for health – for example, vaccine production – not to mention urgent investment in climate mitigation and adaptation.

Another benefit of channelling the SDRs to MDBs is their "preferred creditor" status. Some development banks in the low-income regions where it is already difficult to raise finance from other sources (for example, the Development Bank of Rwanda) have signalled a desire to access increased resources via use of SDRs through their regional banks (the AfDB), as have the RDBs themselves. They are hopeful for progress on the issue and are making proposals on how to implement them. African governments have also thrown their support behind such initiatives.[3]

For all these reasons, there have long been important calls for such a use of SDRs (*TDR*, 2019), but to date, we have seen little progress. There may be some technical challenges to reallocating SDRs to RDBs and MDBs stemming from the requirement to retain their reserve asset characteristic (see Plant, 2022, forthcoming; Lazard, 2022). Research is currently underway on how this could potentially be addressed, to examine ways of structuring any SDRs given to MDBs to both count as their capital and to maintain their reserve asset characteristic.

Given the need for increased scaling up of RDBs, the arguments above suggest it is both important and feasible to rechannel SDRs from countries that do not need them to those countries that urgently require them. This can be done efficiently by rechannelling excess SDRs held by advanced economies that do not need them via RDBs and MDBs, given that (a) RDBs and MDBs are prescribed holders of SDRs; (b) they can leverage their balance-sheet, multiplying their effect; and (c) they can undertake maturity transformation to finance long-term projects around the climate transition and other key development aims. There is, therefore, a strong case economically and technically for such a path to be taken and to do so on a significant scale. Indeed, the main obstacles seem political.

2. Where next?

Other long-standing issues addressed in previous Trade and Development Reports include the important role of deepening and widening regional capital markets. While the potential of public regional financial institutions such as development banks has been the focus of this chapter, private capital markets can play an important complementary role. The Asian region has been particularly active in exploring this possibility, with the creation of the ABMI in 2002 by the ASEAN+3 group of countries (10 original ASEAN states, Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Republic of the Philippines, Singapore, Thailand and Vietnam, plus China, Japan and the Republic of Korea). Its aims were to promote regional financial integration through local currency bond markets and to help Asian countries reduce their reliance on international finance, having suffered in previous economic crises when foreign capital fled abruptly (see Chapter IV; Park and Bae, 2002).

Measured by some yardsticks, such initiatives have been very successful – the Asian region, for example, saw a boom in local currency bonds that are now measured in the tens of trillions of dollars. However, this does not mean the bonds are necessarily "regional" in the sense of raising the resources regionally, nor of investing them in cross-border as opposed to national projects. First, most bond issuers are national (governments or corporations) with the exception of a small number of bonds issued by regional development banks. In Asia, green bonds issued by the Asian Development Bank (ADB) raised some $766 billion over seven years since 2015 (EMEAP, 2022); while in Latin America, bonds issued by the supraregional banks Corporación Andina de Fomento (CAF) and Central American Bank for Economic Integration (CABEI) represented some 5 per cent of the total for the region (Nunez

[3] If recapitalizing them right away with SDRs is a bridge too far, solutions involving hybrid subordinated debt are being actively contemplated. Lazard (2022) suggests allowing SDRs to be invested in a junior fixed income product issued by an RDB, whose equity features would allow some leveraging. The investment risk would be relatively limited, given that such banks are generally significantly less leveraged than Basel-regulated commercial banks.

et al., 2022). Second, the purchasers of these bonds are not necessarily regional. Despite taking the precaution of issuing bonds in local currency, in the Asian region, only Japan has succeeded in largely eschewing foreign obligations (Lim, 2021). In comparison, for Indonesia and Malaysia, some 38 per cent and 31 per cent respectively of local currency bonds are held by non-residents, suggesting these markets are vulnerable to foreign flight in times of difficulty.

This was borne out – to some extent – during the recent Covid-19 crisis. Research by the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), a cooperative organization of central banks and monetary authorities from 11 economies in East Asia and the Pacific, found that having bonds in local currencies was no guarantee of protection from global financial volatility, as the emerging markets in the region with significant foreign investor participation in their local currency bond markets experienced a brief self-reinforcing cycle of currency depreciation, bond fund outflows and rising bond yields. This was especially evident in the sharp unwinding of market positions by foreign investors, who may not have hedged their currency risk (EMEAP, 2022). Although flows eventually returned, this magnitude was extreme – comparable to the outflows in the first few weeks after the collapse of Lehman Brothers in September 2008 during the GFC and more severe than during the taper tantrum in 2013 (EMEAP, 2022, p. 12). The authorities in the region responded to the heavy sell-off of government and corporate bonds by shoring up demand for bonds and supplying liquidity to the financial system, with central banks using a wide range of innovative policies (EMEAP, 2022, p. 16), but the point for current purposes is that they were national responses, not regional.

Finally, there is the question of how the funds are invested, and again, it seems this is usually national in orientation and less often involves cross-border projects. Despite the ABMI, intraregional investment has not picked up significantly in Asia, and the region continues to rely on external capital despite high domestic saving rates (Lim and Lim, 2012). The ADB's green bonds, for example, were raised in a multiplicity of currencies ranging from Australian dollars to euros, Honk Kong dollars, Indian rupees, Norwegian kroners, British pounds, Swedish kroner and Turkish lira and the funds allocated to a special subportfolio linked to ADB lending for eligible projects. While the bank may be a regional one, its lending is not particularly so, potentially reflecting the fact it is very difficult to design and implement large investments that cross national borders. Out of 58 projects listed on renewable energy and energy efficiency, only two were described as "regional" and neither has succeeded in allocating finances anywhere near the approved amounts (ADB, 2022, pp. 11–52). Similarly, out of 41 project loans for sustainable transport, none was regional, and there were no regional projects in the 8 water and urban infrastructure categories.

This matters because the investment demands for climate change and green or sustainable transition need to address challenges that go beyond national borders. It is not easy to link or compare the precise nature of the underlying investments for which bonds are issued, in part because there is no clear framework for reporting or measuring impacts.This is a problem, given the fast growth of these instruments.

For many reasons, the rather limited intraregional aspect of corporate bond issuances and investments may remain so. For one, spending the money across the region requires a degree of harmonization of development plans and objectives, rules and regulations, along with agreement on how to divide the respective costs and benefits. For another, promoting regionally integrated markets requires complete capital account liberalization among the participating countries, and for well-known reasons, this is seen as a risky strategy with uncertain benefits (see *TDR*, 2015). Finally, credit rating agencies (CRAs) are not only constraining many banks' lending operations but are also provoking instability as much as warning of it (see box 6.4).

Box 6.4 Giving banks more policy space: reducing the role of credit rating agencies

CRAs have long held a powerful yet ambiguous position in international finance as both player and umpire, with profound effects on economic policymaking and investor decisions. Their track record in meeting their objective to dampen pro-cyclicality is disappointing, often contributing to macroeconomic instability by amplifying cycles and contagion, with asymmetrical impacts on vulnerable populations. This was evident already in the Asian financial crisis and again during the late 2000s and 2010s; to an extent, the unintended but self-reinforcing impacts of their "spectacular and disastrous power" appear inevitable given the reflexive role played, especially by the "Big Three" CRAs, identified by Barta (2022) as Fitch, Moody's and Standard and Poor's.[4] The irony and costs of this were further evident during the pandemic, when countries availing themselves of G20 debt relief initiatives were faced with downgrades despite attempting to achieve a more sustainable fiscal position (Li, 2021; Griffith-Jones et al., 2022, forthcoming).

Triple-A credit ratings from all the major CRAs are the explicit goal of most MDB capital adequacy frameworks and one of the reasons provided for not participating in recent debt relief initiatives. According to MDBs, these ratings allow them to access markets safely and at low cost, even during times of stress, allowing a much larger contribution to liquidity provision and enhanced fiscal space through continued and extended provision of concessional financing (World Bank, 2020). Consequently, CRA assessments exert considerable influence in determining MDB risk tolerance, de facto embedding rating agency methodologies into internal policies, leading to a highly conservative approach to financing. Evidence gathered by one of the leading CRA agencies (S&P Global) suggests major public banks could increase lending by at least $1 trillion without losing ratings (see *TDR*, 2019).

A recent independent review of MDBs' capital adequacy frameworks commissioned by the G20 argues MDBs can relax their strict aversion to risk, ease capital requirements and increase financing by hundreds of billions of dollars without losing their high credit ratings. The review provides a range of proposals for MDBs, shareholders and CRAs to allow a more realistic and evidence-based assessment of risk. According to the review, the full series of reforms would allow MDBs to start increasing their lending capacity over the next 12 to 24 months by hundreds of billions of dollars but would protect their triple-A rating.

In addition to adjusting their approach to risk tolerance, MDBs and other public and development banks need more support. They require a boost to their capital base, made possible through transfers from the banks' shareholders and augmented by borrowing on international capital markets, with a measured relaxing of their triple-A credit rating where appropriate. Government owners should send clear signals of their support for the banks they own; their developmental mandate should support increased lending to enable more socially beneficial projects to begin.

UNCTAD has long argued that a different kind of CRA is required, one that would support countercyclical policy responses, avoid conflicts of interest in operations, challenge the monopoly of the three major CRAs and refocus priorities on sustainability and financial stability.

A public multilateral credit rating agency (MCRA) could improve and stabilize credit rating assessment of sovereign and public banks with explicit priority to achieve the Sustainable Development Goals (SDGs). An MCRA would provide a distinctive and more effective assessment for developing countries, as it

[4] Mention of any firm, product, service or licensed process does not imply endorsement or criticism by the United Nations.

would integrate both long- and short-term horizons. Moreover, it would develop an alternative model to better align with the realities of developing countries and mainstream climate considerations, including double materiality wherein considerations of both climate's impacts on finance and finance's impacts on climate are recognized. An MCRA would ultimately prioritize the assessment of economic development trajectories, rather than credit-worthiness, while reorienting financing towards productive investment.

Without this kind of innovation, the world is stuck with a system where firms, institutions and even governments are caught in a predictable yet inevitable vicious cycle, where the logic of credit ratings overpowers any stabilizing effects. At the sovereign level, this can have the effect whereby democratically elected governments follow policies imposed by non-elected technicians, which could be the opposite of what their citizens voted for (Barta, 2022).

Another core and related issue is the banks' mandate, including the expectations of their government owners – whether expressed in a vision statement, in the legislation that enacted them or in the reporting requirements and indicators of performance. Nearly all of the public banks established since 2010 have "green" in their title or high up in their mandate (*TDR*, 2021, p. 150), and while much will depend on the actual impact of lending decisions, it is surely significant that the MDBs have made climate pledges with targets for their lending (*TDR*, 2021, pp. 151–153). This matters because, as shown in the recent experience of Covid-19 lending, it makes a very big difference if banks are unambiguous about their role and purpose. Public banks – regional as much as national – with clear and unambiguous mandates in addition to sufficient capital were the ones most able to respond quickly and in line with their members' needs (McDonald et al., 2020; Barrowclough and Marois, 2022).

The regulatory environment is also extremely important in determining the policy space afforded to regional public banks as to all banks; there are concerns that the current rulings which do not recognize the special role of these public banks are causing a negative constraint that needs to be addressed (box 6.5).

Box 6.5 Is financial regulation constraining lending capacity by development banks?

Against a backdrop of limited finance available to support regional integration, the question is whether financial regulation further constrains the ability of development banks to lend at the required scale to finance large cross-border infrastructure projects. Research shows the Basel Capital Accords – financial standards internationally designed to create a level playing field for internationally active banks – constrain both multilateral development banks (MDBs) and national development banks (NDBs) playing regional and international roles in their ability to provide development finance.

A first critical problem arising from the Basel framework is its risk-based approach to capital determination. It is in the nature of banks to evaluate risk in credit allocation decisions. And this is definitely a reason why in the end banks normally do not lend over the long term to the extent required. Basel, however, in adopting a risk-based approach for capital determination, only reinforces a pattern of lending biased against the long term, because it attaches higher risk-weights to long-term exposures (Gottschalk, 2019).

Notably, MDBs (and NDBs with an international role) do finance long-term and riskier projects, as well as large projects. This implies these banks have a portfolio concentration on assets at the higher end of risk buckets. This, in turn, means for the same amount of assets, development banks hold more capital relative to other banks, while the latter have a more diversified portfolio. So from the start, development banks under the Basel framework are penalized, because their ability to lend to larger and riskier projects is constrained. Yet, the Basel framework affects the various categories of development banks differently. MDBs and RDBs are not under the purview of national regulators, but Basel affects these banks by assigning them fixed risk weights, thereby affecting their funding costs.

Under Basel III, 11 MDBs are assigned zero risk weight. These banks are: World Bank Group (WBG); ADB; AfDB; EBRD; Abu Dhabi Islamic Bank (AIDB); EIB; National International Bank (NIB); Commercial Bank of Dubai (CDB); IsDB; CEDB; AIIB. This implies banks who lend to those MDBs do not need to allocate capital for such credits. All the other MDBs face risk weights varying from 20 to 150 per cent, while unrated banks are assigned 50 per cent risk weight. The BRICS founded New Development Bank (NDB), for instance, does not have zero risk weight despite having strong shareholders, and even though, unlike other MDBs, it raises funds in national financial markets, which helps it avoid currency mismatches. According to Basel, MDBs need to meet strict requirements to be granted zero risk weight, which means following “conservative financial policies,” in Basel’s own words. Basel standards, therefore, affect MDB funding costs and, as a consequence, the way these banks manage their balance sheets on the assets side (Gottschalk, 2019).

On the assets side, the biggest constraints for MDBs are the ratings from CRAs. The latter follow Basel standards closely in the models they use to assess risks facing banks. The consequence is that the ratings which these agencies assign to these banks follow the same conservative approach as recognized by Basel. The result is that MDBs and RDBs maintain low gearing ratios (loans to equity ratio) to obtain high ratings, but this limits their leveraging.

National development banks with regional and international roles, in turn, which are under the purview of national regulators, are affected by Basel through Basel’s large exposure framework. The framework restrains banks’ ability to finance large infrastructural and industrial projects. For these banks, international loans also imply currency risks, which are also affected by Basel standards. These risks can be quite significant, to the extent that these banks issue loans in currencies other than those in which they are funded.

Finally, NDBs lending abroad often support innovation using a range of instruments and practices. In this regard, the Basel standards that matter here are those relating to equity finance, an instrument NDBs use to support innovation, and those relating to climate finance, which may involve yet untested clean technologies. Equity exposures from the banking book are assigned risk weights between 100 and 1250 per cent, thereby penalizing NDBs with large exposures. In the area of climate finance, NDBs are becoming increasingly engaged in support for a just energy transition. Supervisors, however, are incorporating climate-related risks in their supervisory work, because of concerns with banks’ vulnerability to such sectors and with weather events that can cause losses to the banks (Gottschalk et al., 2022).

E. CONCLUSIONS AND POLICY RECOMMENDATIONS

This chapter has shown that while regional development banks and funds are needed as much as ever, if not more, they are frequently not adequately supported by their government owners. A massive scaling up and redirection of development finance is needed to face the challenges and opportunities of today's post-Covid-19 and climate-aware world.

- Membership in regional banks and funds can be extremely useful, offering funds, expertise and other benefits, including a voice more commensurate with economic weight and more choices of sources of finance.
- However, regional arrangements cannot solve the limitations of the international financial architecture; they may be a useful stepping-stone, but some countries will never receive the kind of support needed from the region, especially during systemic crises when all countries in a region may be hit at the same time.
- Regional liquidity arrangements were not used much during Covid-19, and bilateral currency swaps were the main source of liquidity in the GFSN. While RFAs provided vital support to those countries that tapped them; the trend of bilateral swaps is a concern because many countries lack the capacity to negotiate them.
- In comparison, regional development banks were a major provider of counter-cyclical funds during Covid-19, especially those banks that were well capitalized and had a clear public purpose. Some banks increased lending by more than 100 per cent to provide relief and recovery; others supported regional research and development to find a Covid-19 vaccine.
- Looking forward, regional banks and funds need more reliable and sufficient capitalization (i.e. much more than they get now), more representative governance and economic performance measures and indicators that reflect their catalytic developmental role and allow them to fulfil it, rather than narrow financial measures.
- RDBs and RFAs can usefully receive new or unused allocations of special drawing rights, as currently under debate. One benefit DBs offer for the effective use of SDRs (versus national budget transfers) is that they can be leveraged; another is that they are potentially seen as politically more independent.
- G7 or other high-income owners in RDBs should increase their capitalization and policy space to allow the banks they co-own to support more experimental, developmental,green technology and enterprises. Regional banks could also seek new members to beef up their capital bases.
- Regional credit ratings or regional regulatory agencies are needed to overcome the stranglehold of the "Big Three" CRAs. Some banks have it in their mandates that they must achieve AAA status from at least two of these ambiguous – private sector – institutions.
- Finance can be found at times of urgency, as during the Covid-19 years, but this does not mean it goes where it is most needed. Some countries missed out in the pandemic. RDBs can help by providing public leadership in coordinating and delivering reliable long-term finance. In their special role as a bank with a public purpose, they can tap both public and private channels, and as they have technical expertise and management skills, they can ensure these are directed to developmental purposes.

- Regional capital markets are seen by some as an important complement to national markets and a potential counterpart to public bank lending; for these reasons, some regions have keenly promoted them. However, simply issuing bonds in local currency does not offer protection from exchange rate volatility and cross-border capital flight.[5]
- Other forms of financial arrangements, such as regional bonds (social, blue and green), are seen by many as offering hope for the financing of regional public goods. But the evidence does not yet support this, and it is likely that regional market-based financial institutions will suffer the same obstacles as regional projects everywhere – including tension about real or perceived allocation of the benefits and costs between the individual members of any regional grouping. For such reasons, it is hoped that public regional institutions, with their intergovernmental processes and negotiation fora, coupled with their potential for taking a longer-term view than the market, can address some of these. For such reasons, South—South sharing of experiences and solution-seeking, in addition to North—South, North—North, triangular and indeed global arrangements, will continue to be important for the future.
- While regional arrangements have been able to offer a lot in short-term and liquidity financing, these are still really only regional on one side of the equation – the supply side – by pooling finance to make a reserve fund larger than what individual countries could create. Demand for lending is still mostly national, and this limits the provision of urgently needed public goods and the removal of public bads. Most of the regional multilateral banks lend quite a small proportion of their total to projects that are cross-boundary or multicountry, certainly less than one quarter. It seems regional projects require more harmonization between countries in terms of regulations, physical infrastructure, regional procurement policies and the ability to perceive benefit and share it among regional members fairly. This is most evident in the issue of oceans or blue-based lending.[6] Many banks have the ambition to lend more regionally, but this will require significant negotiations and soft-capital investments first.

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[5] Some of the new regional arrangements are an unusual form of quasi-public and quasi-private structure, as yet untested. For example, a new regional repurchasing agreement ("repos") to help participating countries reduce their cost has been created by United Nations Economic Commission for Africa (UNECA) and Pimco USA Liquidity and Sustainability Facility. However, this would perhaps not appear as attractive had banks in Africa not been so capital-constrained in the first place.

[6] For example, only a very small proportion of total loans from the Green Climate Fund appear to be targeted to oceans or blue economy activities. Many of these are regional or multi-country project loans, reflecting the fact that ocean resources (such as fish) and ocean-related problems (such as pollution) cross national borders and thus need multilateral responses. Co-ordinating these is typically more complex and time consuming than more simple single country loans for obvious reasons (Vivas et al., 2021, pp. 7-9).

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