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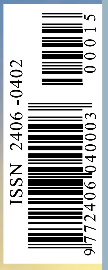

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How to Reboot Global Development Finance

Erik Berglof

THE CHALLENGES to the global commons, like climate change and pandemics, often leave the poor more exposed and invariably more vulnerable. The fight against poverty and inequalities, particularly in Africa, and the increasingly interlinked battle against climate change must be stepped up to meet the global Sustainable Development Goals (SDGs) by 2030. Massive increases are needed in infrastructure spending and development finance can help ensure that the appropriate technologies are put in place. At the same time development assistance is coming under intensified scrutiny by voters everywhere. The pressure to show results is building in every part of the development system.

Two recent reviews of the development finance architecture have taken stock of where we are in terms of capacity to deliver. The G20 Eminent Persons Group on Global Financial Governance (EPG), chaired by Tharman Shanmugaratnam, then Deputy PM of Singapore, was the first to look at the entire system of international financial institutions, including the global and regional development institutions and the International Monetary Fund. It presented its final report in October 2018 and was then followed by the EU Wise Persons Group on the European Development Finance Architecture (WPG). This group essentially applied the EPG systemic approach to Europe in its report to the European Council in October 2019.

Both reviews recognize the many achievements of the global system in terms of income convergence across countries and massively improved health outcomes in the developing world. Yet inequalities within countries have been growing in many places and we are lagging dramatically in the addressing the threat of climate change.

Erik Berglof is Director of the LSE Institute of Global Affairs and a member of the EU Wise Persons Group of European Development Finance Architecture. You may follow him on Twitter @ErikBerglof.

Photo: WIKIMEDIA COMMONS

The Euro statue in front of the ECB in Frankfurt

The responsibility for both successes and failures mainly falls on national governments rather than the international financial institutions, but the global system has not sufficiently supported governments in their efforts. The poor delivery reflects a lack of coherence across institutions and between different levels of government operationally and financially, but also in terms of policies pursued and coordination within the governments of the shareholder countries.

More Coherence Needed

The EPG report emphasizes the lack of coherence in terms of standards and codes of conduct, which frustrates efforts of recipient governments to pursue effective policies and increases the cost of financing. Its main proposal for increasing coherence is the so-called country platforms. These coordination devices are meant to bring in all relevant external development actors, including national, regional, and global institutions, but they must be owned and controlled by the recipient governments.

The country platforms are also meant to help "crowd in" international private and institutional capital. Without massive increases in these funds the SDGs will not be met by 2030 as envisioned.

The main challenge is the level of risk in developing and emerging economies. Some of that risk can be insured against today, but most cannot. Part of the problem is the lack of coherence across development institutions. More standardization of conditions and sharing of information on borrowing entities could increase the scope for risk insurance substantially. The EPG is encouraging the World Bank risk insurance arm—the Multilateral Investment Guarantee Agency (MIGA)—to open up more to other development institutions; it is also calling for an increase in MIGA's resources.

More convergence of standards and greater sharing of credit histories would also facilitate pooling of risks across investors—through securitization, for instance. One such example is the Dutch ILX fund, which pools so-called B-loans of 13 development finance institutions and then offers institutional investors in advanced economies to invest in the fund. Another option may be to allow private and institutional capital to invest through the development finance institutions. The EBRD Equity Partnership launched in 2014 created a synthetic vehicle replicating part of the equity portfolio of the bank and then invited institutional investors to contribute capital relying on its governance mechanisms. The model attracted modest interest, but the timing was unfortunate, coinciding with Western sanctions on Russia, EBRD's most important market.

The EPG report is also unique in that it looks at the entire international financial system, including the IMF, and considers what can be done to reduce the risk of financial crises which have devastated many developing and emerging economies. An important problem with the SDGs is that they have not yet been properly costed—these goals must not be met at the expense of financial fragility. The IMF has an important role, working with the World Bank and regional and national development finance institutions, in ensuring that debt sustainability is one of the core standards implemented across country platforms and throughout the development system.

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The EPG also encourages the IMF to embark on a review of its approach to capital controls, recognizing that the responsibility for the volatility of capital flows rests not only or even mainly with the recipient countries, but also with the sending countries, particularly those like the United

States, the EU, Japan, and, increasingly, China, whose monetary and fiscal policies have systemic impact on the global economy. The IMF could also do much more to support fragile states become more resilient by developing basic institutions and by strengthening state capacity to raise taxes and developing the local financial system and thus increase domestic resource mobilization.

Europe Needs Stronger Architecture

The WPG report confirms that many of the observations from the EPG also apply to the European development finance system. The group provides a damning assessment of the current EU arrangements with weak development knowledge in core institutions, unproductive overlap between institutions and, as a result, little systematic evidence of development impact. There is very little coordination between national, EU-level, and global development finance institutions.

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The WPG suggests that to address these weaknesses Europe needs its own development bank: a robust and agile partner that can cooperate with (but also challenge, as required) Chinese institutions operating within the framework of the Belt and Road Initiative and the new reinforced American development agencies. But such an institution could also serve as a repository of development knowledge and experience. The Group came up with three stylized options for how to build a European development bank, but there might be a fourth alternative combining the best features of existing institutions.

So why does the WPG think that we need a European development bank? First, it is about the scale and urgency of the challenges globally and in its neighborhood. Most of all, Europe needs to strengthen its capacity to respond to the threats and opportunities in Africa. Ex post facto crisis management responses as we have seen over the last decade are not sustainable for the EU's own internal unity and cohesion in the long run. More generally, Europe must be able to operate in environments with significant state fragilities.

Second, it is about geopolitics. The new European Commission under Ursula von der Leyen has turned its attention to the accelerating merging

of geopolitical and economic spheres around the world. Europe now urgently needs to develop its own economic sovereignty policy—and must do so without giving up its ambition to forge multilateral coalitions. Development finance is a critical building block. The current situation in Afghanistan provides an illustration. The Trump Administration is keen to withdraw its troops and Europe is likely to be left the bill for reconstruction, but it lacks an effective instrument to deliver this assistance.

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Third, it is about the efficiency and effectiveness of current European development assistance. Europe coughs up close to two-thirds of all global assistance, but—as the WPG painstakingly documents—the impact should be much greater. What the EU does through national institutions and at the EU and global levels is often poorly coordinated. Coherence across different EU directorates could also improve. There are already signs that popular support for development assistance is decreasing and OECD/DAC data shows that the level of actual assistance is falling for the first time in a decade.

The two existing European development finance institutions—the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB)—increasingly run into each other. Both have their strengths, but are weak where development needs are greatest: in fragile states, particularly in sub-Saharan Africa. As the WPG notes, the EBRD is a proper development institution with a broad range of activities, strong policy dialogue with countries, and a heavy presence on the ground. The EIB's main strength is inside the EU. It is a policy-taker with most of its staff situated in Luxemburg.

In short, the European development finance system does not function as a system in the sense emphasized by the EPG. The existing architecture badly needs an overhaul. Just maintaining the status quo of the current institutional set-up, even enhanced by the short-term measures suggested by the WPG, is not acceptable if Europe is to build its credibility and capacity for the long game. There is still scope to accommodate a more ambitious approach within the current discussions over EU's next budgetary cycle.

Creating a Sustainable Development Bank

Yet, starting a completely new institution would require huge investments in financial capital and recruitment of specialized staff. Doing so would also take time—particularly precious if we are to achieve the SDGs by 2030. The WPG developed one option that would create a new bank from scratch with both EBRD and EIB, and the Commission as shareholders, but finance ministers have already rejected it as being too expensive, too complicated, and too slow.

> *Both the EBRD and the EIB have their strengths, but both are weak where development needs are greatest: in fragile states, particularly in sub-Saharan Africa.*

The two remaining options are to build the new bank from either the EBRD or the EIB. The WPG was clear that, from a development point of view, EBRD is the preferred option. Unfortunately, the EU, particularly after Brexit, only controls a little over half of the votes, whereas many important decisions require larger majorities. If Europe were to provide more capital to the EBRD, non-EU shareholders would have to reduce their voting share. There are no guarantees that they would agree.

The EIB option involves separating out its non-EU assets (about 10 percent) into a new subsidiary entirely controlled by European entities. This subsidiary could have multiple owners, including the Commission and even national development institutions, like Germany's state-owned development bank (KfW) or the French one (AFD). The large, and possibly overwhelming, challenge is to turn the EIB or its subsidiary into a development institution, while it lacks basic features such as an inclusive shareholding or deep local presence.

Option Four

All three proposed options have their pros and cons, but there might be an Option Four not proposed by the WPG. This proposal would weld together the different features of the other three options in an interesting and possibly politically more palatable way: by involving the national development institutions more in the system. These institutions differ widely by country in terms of size and range of activities, but many cover important areas, like health and education, and have rich experience operating in countries with significant fragilities.

The national development finance institutions also offer EU continuity in other parts of the world together with the World Bank, the African Development Bank, and other multilateral actors in which the EU is invested, where EBRD and EIB are weak or not

present. They could be integrated into an open European development finance architecture offering global windows through which national, regional, and global institutions could compete to implement EU assistance projects under a coherent European development policy.

Many of the national development finance institutions are small, often heavily concentrated to a region or even individual countries. To strengthen their lending capacity and bring down their cost of capital most of them could benefit from a capital backstop. A "bank-of-banks" could be established to help (an embryonic arrangement already exists) and EIB's very large balance sheet and funding capacity could be an important part of such a backstop.

Why overhaul European financial development architecture now? Obviously, the challenges of climate, European immigration, and African development are urgent; but it is also a convenient time in the European calendar as the next EU budget is being prepared.

Another feature would be to separate the activities of the EBRD and EIB. They already run up against each other in many countries and sectors, and current expansion plans would increase the overlap even further. EIB could focus solely on EU countries, with its assets outside the EU transferred to the EBRD. Conversely, the EBRD could hand over its assets in EU countries to focus on the European neighborhood and sub-Saharan Africa. Such an asset exchange would not be easy, but it was actually prepared once (in 2013).

In this Option Four, the third and central component would be to recast the EBRD as the European Sustainable Development Bank working along national and international institutions like the World Bank and the African Development Bank, where Europe should remain engaged. To increase its capacity to lend, additional capital would have to be injected. Only EU shareholders are likely to contribute additional capital and thus their voting shares should increase, but non-EU shareholders, including the United States, which currently holds the largest block, the United Kingdom and, importantly, recipient countries, would still be represented. This would be the European multilateral approach.

In this option, the EIB would focus on becoming the European climate bank and serve as the financial backstop for the national development finance institutions. Perhaps it could also participate in some sovereign lending outside the EU, possibly for climate purposes. This is an area where the structure and scale of EIB is well suited.

So why overhaul European financial development architecture now? Obviously, the challenges of climate, European immigration, and African development are urgent; but it is also a convenient time in the European calendar as the next EU budget is being prepared. Equally importantly, we are in the rare position of already having an institution, the EBRD, with a proven track record and additional lending capacity facing important strategic choices over the next months.

Europe does not just need its own development bank: it deserves an efficient and impactful institution to do justice to the extraordinary generosity of its citizens and the shared multilateral mission to solve our overwhelming global crises together.

As Brexit looms, non-EU shareholders of the EBRD will soon face a stark choice between reducing their relative stakes and witnessing the creation of a new European institution where neither they nor recipient countries were owners. Without access to EU grants, the EBRD will not be viable in many of its current sectors and countries of operations—eventually it might have to close down. Letting the EBRD flounder and fade away would be a tremendous waste of the time and effort put into building the institution, not to speak of its 3,000 development professionals and the rich experience accumulated over close to 30 years. Building institutions takes a long time and huge investment.

Instead, the EU and its international partners should take the opportunity to use the EBRD. In an age of increasing uncertainty, growing international threats, and fundamental challenges to multilateralism we need solid institutions more than ever. Europe does not just need its own development bank: it deserves an efficient and impactful institution to do justice to the extraordinary generosity of its citizens and the shared multilateral mission to solve our overwhelming global crises together.

From Words to Deeds

The two aforementioned reviews have both been positively received, but implementation is wanting. Looking at what has and has not happened after the presentation of the reports could provide us with some additional insights into the functioning of the system and its capacity to transform itself. Of course, the EPG final report was submitted a year earlier and there is more information on how it has been implemented, but given the rushed agenda for the WPG follow-up we already have some early indications.

As for the EPG, the Japanese G20 Chair, when taking over from the Argentinians, embarked on an initial prioritization exercise to determine which of the 22 EPG proposals were most urgent, important, and most realistic to be pursued by G20 finance ministers and the group's leaders. The country platform proposal was the one judged to be most politically feasible, but in the end the meetings in Fukuoka and Osaka did not produce agreement. There now seem to be some prospects for an agreement in the G20 International Financial Architecture working group, but it is hard to see how the Saudi G20 presidency will be able to carry this issue or any of the other proposals from the EPG. That Italy, who will take over after Saudis, will pursue them with more vigor is far from clear.

It is ironic, but not entirely surprising, that what might stop these European reforms is the weakness of supranational governance.

However, individual institutions have taken some of the proposals. The World Bank has unilaterally announced that it is piloting a large number of country platforms. The new president, David Malpass, has taken on this idea as his own, perhaps not surprising as it can be interpreted as giving the World Bank a natural role as the "donor coordinator." Some of the regional banks have also taken on part of the agenda, and there are some signs of increased cooperation between institutions following the EPG report. Interestingly, the IMF—which, throughout the EPG process, was the most reluctant reformer—is undertaking an institution-wide review of its approach to capital controls, and there is a noticeable increase in the attention it is paying to fragile states, something proposed by the EPG.

Yet none of the institutions is likely to pursue the wholesale systemic change envisioned by the EPG. The presidents of the development banks in most cases have considerable powers, but institutional constraints, particularly their board structures, prevent them from pushing systemic reforms. Change has to come from the outside, arguably most likely from the G20.

The most concrete follow-up to the EPG is, in fact, the European WPG. While the latter was motivated by some specific tensions in the European architecture and the timing determined by the EU budget cycle, the approach was clearly that of the EPG. The WPG proposed both some short-term measures, some of which were already underway, and the more long-term architectural reforms with a new development bank. In this way the European follow-up went even further than the EPG itself in that it called for new institutions to be created or old ones converted.

It is ironic, but not entirely surprising, that what might stop these reforms of the international financial system is the weakness of supranational governance. National efforts have been more effective. China has very effectively managed to radically transform its approach to development through the creation of the AIIB and the Belt and Road Initiative. Meanwhile, the United States has just created its International Development Finance Corporation (DFC) through a radical merger of the Overseas Private Investment Corporation (OPIC) and the Development Credit Authority (DCA) of the U.S. Agency for International Development (USAID). Whether the EU will succeed in creating a European Sustainable Development Bank will be an important test for the authority of the EU institutions. Yet, at the moment, progress at the EU level seems more plausible than at the global level, reflecting the greater effectiveness of the European institutions compared to those at the global level.