



# DIIS REPORT

## **ALTERNATIVE DEVELOPMENT FINANCING MECHANISMS**

PRE-CRISIS TRENDS AND POST-CRISIS  
OUTLOOK<sup>1</sup>

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<sup>1</sup> This study represents the final one in a series of studies on non-traditional instruments for financing development in Sub-Saharan Africa published by researchers at the Danish Institute for International Studies and sponsored by Danida. Previous contributions provide detailed analyses of individual instruments: the present offers a more unified treatment, brought up to date. Errors and omissions are the author's.

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## I. Introduction

External financial flows have long held a central place in debates about how to promote socio-economic development in poor countries. Alternative development theories typically map into different views regarding the desirable form and volume of external inflows. Over the past decade, development policy has witnessed a clear shift towards a poverty reduction agenda. Unsurprisingly, this has been accompanied by changes in views concerning development finance. A dominant refrain of the present agenda is that 'traditional' approaches to development finance, characterised by official bilateral and multilateral assistance to discrete projects through a combination of loans and credits, have been inadequate. In response, reforms of traditional aid and alternative approaches to financing have been advocated.

This view is implicit in high-profile initiatives such as the Millennium Development Goals (MDGs) and Tony Blair's Commission for Africa. The UN Millennium Project's (2005) action plan to achieve the MDGs, for example, states that, although the international community possesses the core knowledge to reduce poverty, the financial means and political will to do so have been lacking. Although estimates of the additional financing needed to achieve the MDGs on a global basis vary, ranging from USD 50 billion per year to over USD 100 billion, a consistent theme is that an approximate doubling, at least, of real aid resource transfers is required (for discussion see Clemens *et al.*, 2007). Other critiques of traditional aid also have gained prominence. Its supposedly greater volatility compared to domestic sources of revenue (Bulir and Hamann, 2006) is perceived to be detrimental to macroeconomic stability (Hudson and Mosley, 2008), as well as to growth and welfare more generally (Arellano *et al.*, 2005). Donor allocations of aid also are seen to be frequently guided by self-interest rather than recipient needs (Berthélemy, 2006). Finally, the Paris Declaration on Aid Effectiveness suggests a number of improvements to increase the poverty-reducing effect of aid, such as harmonization with recipient country systems.

As might be expected, some changes in development finance have occurred in response to the above challenges. Reforms in traditional aid have embraced greater alignment with country-led poverty-reduction plans, wider use of multi-year programme and budget support modalities, and greater use of grant-based as opposed to credit-based instruments in low-income countries. However, recent reviews suggest that the extent of these reforms has been limited, and there remains a wide gap between formal commitments to scale up ODA and actual increases (Wood *et al.*, 2008; OECD,

2008; also Section 2). Consequently, and particularly in view of the estimated size of MDG funding needs, alternative approaches to development financing have received increasing emphasis (e.g., World Economic Forum, 2006). These include all kinds of private-sector flows, specialised multi-donor partnership funds, and the return of various official non-DAC donors (i.e. non-members of the Development Assistance Committee of the OECD) such as China and India.<sup>2</sup>

The main purpose of this study is to assess the recent evolution of non-traditional approaches to development finance. Specifically this will include: (1) an examination of the characteristics of the alternative financing mechanisms that have emerged over recent years; and (2) an analysis of their (combined) contribution to addressing development financing challenges in the poorest countries. The motivation for the focus on these alternative financing mechanisms as opposed to traditional flows goes beyond the critiques of official development assistance (ODA) mentioned earlier. Recent changes in the development finance landscape must also be placed in the context of broader trends such as financial globalization and the (not unrelated) emergence of large current-account surpluses in certain developing economies. However, recent events associated with the global financial crisis call into question the resilience of private-sector flows to low-income developing countries. For this reason, it is also useful to consider the future prospects of alternative financing mechanisms.

Given the broad intentions of this study, the objective is not to give a detailed review of individual financing mechanisms. Numerous studies of specific financing alternatives can be found (e.g., the contributions in Ketkar and Ratha, 2009), with particularly extensive treatments of the role of China and India in Africa (e.g., Goldstein *et al.*, 2006). However, it is often the case that previous studies retain a relatively narrow focus. As such, they fail to capture either the comparative characteristics of alternative financing mechanisms or the extent to which different instruments (or actors) may act as substitutes or complements to ODA. This study seeks to address these shortcomings by providing an integrated and up-to-date perspective on recent developments. In assessing alternative approaches to financing, the study also does not attempt to consider the full range of potential developmental impacts and issues. This would be a herculean task. In contrast, the focus remains on the extent to which more specific

<sup>2</sup> The important role of alternative sources of funding is explicitly advocated by the United Nations to achieve the MDGs: "The public and the private sectors both have a role in almost every form of investment needed for the Goals. [...] Public and private investments, when well designed, tend to be complementary, not rivals or substitutes. It is therefore a huge mistake to be dogmatic about public versus private investments. Both are needed" (UN Millennium Project, 2005: 46).

*financing* challenges are addressed. Finally, the analysis concentrates mainly on issues relevant to sub-Saharan African (SSA). This is because the majority of low-income countries are located in this region and because these countries are generally deemed to be furthest behind in meeting key MDG progress indicators (for data and critical discussion, see Easterly, 2009). Consequently, getting development finance “right” would seem to be most important here.

By way of structure, Section 2 seeks to summarise what we know about alternative approaches to development financing. The contribution of these changes to address the financing challenges facing low-income countries is assessed in Section 3. In doing so, a conceptual framework is introduced that draws attention to the issue of the incentive compatibility between alternative financing instruments and different kinds of developmental challenges. Section 4 reflects on the implications of the recent financial crisis for development financing as a whole, while Section 5 offers conclusions.

## 2. Trends in development financing

### 2.1 The aggregate picture

At the outset it is useful to acquire a sense of aggregate changes in the development financing landscape. These are summarised in Table 1 and Figure 1, which distinguish between SSA and all other developing countries. As can be seen, while some scaling-up of ODA has taken place since 2000, principally through

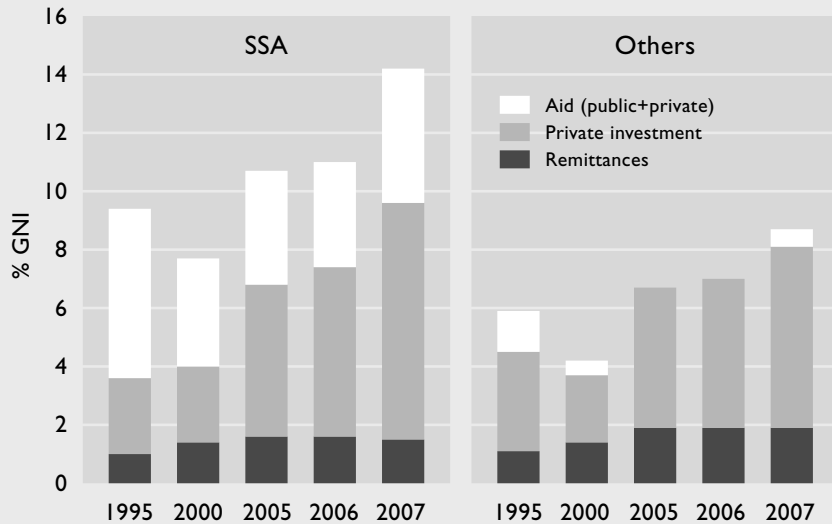
Table 1: Net official and private financial flows to groups of developing countries (USD billions, constant 2000 prices)

|  | (I) Sub-Saharan Africa |      |      |      |      | (II) Non-SSA developing countries |       |       |        |        |
|--|------------------------|------|------|------|------|-----------------------------------|-------|-------|--------|--------|
|  | 1995                   | 2000 | 2005 | 2006 | 2007 | 1995                              | 2000  | 2005  | 2006   | 2007   |
| <i>Official flows</i>  | 18.1                   | 10.9 | 24.9 | 30.7 | 26.8 | 74.4                              | 23.4  | 0.5   | -5.1   | 53.6   |
| Grants (non-debt)  | 13.5                   | 9.3  | 18.0 | 19.6 | 22.4 | 34.6                              | 29.3  | 50.5  | 50.3   | 54.0   |
| Debt relief (net)  | 0.7                    | 0.8  | 7.9  | 13.3 | 3.0  | 0.9                               | 1.0   | 13.8  | 4.7    | 4.9    |
| Credits (incl. IMF)  | 3.9                    | 0.7  | -1.0 | -2.3 | 1.3  | 38.9                              | -6.9  | -63.9 | -60.2  | -5.3   |
| <i>Private flows</i>   | 14.0                   | 14.6 | 39.7 | 47.1 | 63.9 | 253.9                             | 220.5 | 597.0 | 703.9  | 867.5  |
| Net equity flows   | 5.0                    | 9.1  | 20.5 | 26.6 | 31.1 | 77.1                              | 126.2 | 222.3 | 244.2  | 308.7  |
| Direct investment  | 1.8                    | 5.0  | 13.8 | 13.2 | 22.3 | 65.2                              | 116.9 | 166.5 | 164.7  | 191.7  |
| Portfolio equity   | 3.2                    | 4.2  | 6.7  | 13.4 | 8.8  | 11.9                              | 9.3   | 55.8  | 79.5   | 117.0  |
| Net debt flows   | 3.7                    | -0.8 | 7.1  | 7.7  | 18.7 | 113.0                             | 10.0  | 200.5 | 263.3  | 348.9  |
| Bonds  | 0.9                    | 1.0  | 1.2  | 0.1  | 5.0  | 24.7                              | 18.5  | 46.6  | 24.2   | 63.8   |
| Banks (long-term)  | -0.5                   | -0.7 | 3.4  | -1.4 | 10.5 | 28.8                              | -3.2  | 74.0  | 161.2  | 175.7  |
| Short-term & other   | 3.3                    | -1.1 | 2.5  | 8.9  | 3.1  | 59.5                              | -5.3  | 80.0  | 77.9   | 109.4  |
| Remittances  | 3.5                    | 4.6  | 8.4  | 9.2  | 9.4  | 59.0                              | 79.0  | 164.3 | 186.9  | 198.5  |
| Private grants (net)   | 1.8                    | 1.7  | 3.6  | 3.7  | 4.7  | 4.7                               | 5.3   | 9.9   | 9.4    | 11.4   |
| <i>TOTAL (ex. debt relief)</i>                                 | 31.4                   | 24.7 | 56.7 | 64.4 | 87.7 | 327.4                             | 242.9 | 583.6 | 694.0  | 916.2  |
| <i>Memo items (given as % GNI unless otherwise indicated):</i> |                        |      |      |      |      |                                   |       |       |        |        |
| GNI (constant 10 <sup>9</sup> USD)                             | 333                    | 320  | 529  | 586  | 613  | 5,518                             | 5,815 | 8,761 | 10,028 | 10,627 |
| Total (excl. debt relief)                                      | 9.4                    | 7.7  | 10.7 | 11.0 | 14.3 | 5.9                               | 4.2   | 6.7   | 6.9    | 8.6    |
| Official flows   | 5.4                    | 3.4  | 4.7  | 5.2  | 4.4  | 1.3                               | 0.4   | 0.0   | -0.1   | 0.5    |
| Private flows  | 4.2                    | 4.6  | 7.5  | 8.0  | 10.4 | 4.6                               | 3.8   | 6.8   | 7.0    | 8.2    |
| Trade balance  | -5.6                   | -0.2 | 0.3  | 0.4  | -0.6 | -2.2                              | 0.0   | 2.5   | 3.2    | 3.1    |
| International reserves   | 6.8                    | 11.5 | 14.5 | 17.8 | 15.6 | 9.6                               | 11.9  | 21.7  | 24.2   | 23.1   |
| FDI profit remittances   | 1.3                    | 2.5  | 3.5  | 2.2  | 3.2  | 0.7                               | 1.2   | 1.8   | 2.1    | 2.1    |

Notes: developing countries include all countries not classified as high income; official flows correspond to data for all donors held by OECD-DAC; net debt relief encompasses debt-related grants minus offsetting entries; private grants exclude ODA channeled through private agencies such as NGOs.

Source: author's calculations from World Bank (2008a, 2008b), OECD-DAC (2008).

Figure 1: Net capital flows to SSA and non-SSA developing countries (% GNI)



Notes: Aid refers to official flows + private grants; private investment covers all private flows excluding remittances and private grants

Source: calculated from Table 1

increases in grants, this expansion has been modest in historical perspective. For example, total net official assistance to developing countries fell from USD 92.5 billion in 1995 to USD 80.4 billion in 2007 (at constant 2000 prices). This point is reinforced when one excludes the contribution of large-scale debt relief in 2005 and 2006, as well as increases in ODA to Iraq, Afghanistan and other fragile states.<sup>3</sup> Thus, it is evident that commitments to increase aid in support of the MDGs, such as a doubling of flows to SSA by 2010 compared to their 2004 levels, remain extremely optimistic. Indeed, in its latest review of aid disbursements and future commitments, OECD-DAC (2008) estimate that USD 34 billion needs to be added to aid budgets for donors to fulfil their commitments made at the G8 Gleneagles summit in July 2005; this is equal to 35% of 2007 total net ODA, excluding debt relief.

<sup>3</sup> According to OECD-DAC (2008) data for the three years from 2005 to 2007, Iraq, Afghanistan, Sudan, Pakistan and the Palestinian Administered Areas together accounted for 22.8% of total real country-allocated net ODA (excluding debt relief).



The contribution of ODA is even less impressive when considered in relation to other indicators. For example, compared to changes in gross national income (GNI), net official flows to both SSA and non-SSA developing countries including debt relief were around one percentage point lower in 2007 than they were in 1995. Of course, this partly reflects robust economic growth across the developing world over the past eight years. According to IMF estimates (IMF, 2008a), emerging and developing economies grew at 6.5% per year on average between 2000 and 2008, compared to 3.2% during the 1990s. Given that much of this growth has been export-led, very substantial improvements in trade balances and international reserves have also been seen. As a result, many developing countries, such as Argentina, Brazil, Nigeria and Turkey, have been able to repay large stocks of external debt. On a net basis, therefore, demand for (concessional) external credit has fallen sharply, prompting a number of analysts to comment on the marginalization of multilateral institutions such as the IMF (Radelet, 2006).

In contrast to the performance of ODA, private flows to developing countries (including SSA, see Section 2.2) have shown extremely rapid growth since 2002. The global expansion of private equity and debt flows has been discussed in detail elsewhere and does not require extensive treatment here (for example, see UNCTAD, 2008; World Bank, 2008a; IMF, 2008b). Nevertheless, it is useful to highlight the fact that the surge in these flows is typically explained with reference to both global 'push' and domestic 'pull' factors. With regard to the latter, improvements in the current account of the balance of payments, international reserves, debt sustainability and macroeconomic management indicators have been taken as evidence of a reduction in the market, credit and country risks of investments in emerging markets. On the other hand, low yields in advanced markets – proxied by US policy interest rates as well as increases in global liquidity associated with the large reserve asset funds held by some of the major emerging market nations – supported a search for higher returns by investors from rich countries. The boom in global commodity prices from 2003 to 2008, frequently interpreted as being due to a permanent expansion in global demand arising from China and India (see Smick, 2008), further accentuated investor interest in developing-country investment opportunities. These trends are apparent in the increase in net portfolio equity flows to developing countries, which rose from USD 15.2 billion in 1995 to USD 125.9 billion in 2007 (in real terms). Consequently, and as illustrated in Figure 1, private investment flows have grown at almost double the rate of income growth over the same period, expanding from 3.4% of GNI in 1995 to 6.3% in 2007 (taking SSA and non-SSA combined).

Alongside private investment flows, private remittances and private grants also have seen substantial increases. For all developing countries, remittances now significantly eclipse ODA by total value, despite the fact they were only equal to 70% of official flows in 1995, although smaller, private grants also have become more significant. These grants, which include philanthropic funds as well as the privately financed activities of non-governmental organizations, now equal around one fifth of net official flows to developing countries. In light of only modest real increases in official flows, together these trends suggest that private capital flows of all sorts have come to play a much more dynamic and expanded role in the developing world. However, the extent to which these and other non-traditional flows genuinely help address development financing challenges in low-income countries remains to be demonstrated.

## 2.2 Private investment flows to SSA

As indicated in the previous sub-section, net private investment flows to SSA have risen dramatically, recently becoming larger than official assistance to the region (see Figure 1). While much of this corresponds to foreign direct investment, Table 1 also suggests that portfolio flows (equities, bonds and commercial bank lending) to SSA have grown substantially. However, it is well known that much of this relates exclusively to South Africa, which has one of the most active equity and debt markets outside the advanced countries. As a result, it is necessary to examine the distribution of private flows to SSA at the country level. An initial problem here, however, is the quality of the data.<sup>4</sup> Standard cross-country datasets (such as World Bank, 2008a) are generally compiled using data from national authorities. In countries where external private investment has been small, systems to accurately monitor and classify such flows remain weak. In particular, foreign participation in domestic primary and secondary markets (e.g. through global equity funds) can often be overlooked. This is because these kinds of flows are much more difficult to identify in comparison to direct (primary) issuance of capital to international investors, which often occurs in large lump-sum transactions and requires specific regulatory approval. This means that cross-country measures of portfolio inflows may be gross underestimates.

Despite the above, some progress can be made. Table 2 isolates the weight of South Africa in the aggregate figures, showing the share of private investment flows going to other Sub-Saharan African countries as a proportion of total flows to the entire

<sup>4</sup> For more detailed discussion, see Bhinda *et al.* (1999). Note that many of the concerns regarding data quality raised by these authors continue to be valid.

**Table 2: Share of regional and global capital flows going to Sub-Saharan Africa (SSA) excluding South Africa (RSA)**

| Basis  | Flow                      | 1970s | 1980s | 1990s | 2000-06 |
|--|---------------------------|-------|-------|-------|---------|
| Share to SSA excluding RSA as % all SSA                  | ODA and official aid      | 100.0 | 100.0 | 98.2  | 97.4    |
|  | Foreign direct investment | 98.1  | 114.1 | 108.5 | 87.6    |
|  | Non-bank portfolio flows  | -     | 51.2  | 0.8   | 0.8     |
|  | Commercial lending        | 100.0 | 100.0 | 77.9  | 36.8    |
| Share to SSA excluding RSA as % all developing countries | ODA and official aid      | 19.6  | 30.6  | 27.9  | 29.6    |
|  | Foreign direct investment | 14.9  | 6.1   | 4.9   | 6.3     |
|  | Non-bank portfolio flows  | -     | 1.2   | 0.1   | 0.1     |
|  | Commercial lending        | 7.0   | 7.9   | -1.3  | 2.4     |
|  | <i>Memo: GNI</i>          | 6.8   | 5.3   | 3.4   | 3.6     |

Notes: Non-bank portfolio flows include portfolio equity and bond flows; commercial bank lending represents non-concessional bank loans; all values are stated on a net basis; calculation for GNI refers to SSA as a share of all developing countries; all proportions refer to individual instruments (flows).

Source: author's calculations from World Bank (2008b).

region (as well as to all developing countries). This exercise clearly shows that non-bank portfolio flows have been dominated by South Africa (RSA) since at least the early 1990s, when the country regained access to international markets. To a somewhat lesser extent, the same is the case for commercial bank lending, indicating that the combined value of private portfolio flows to the region has been consistently small relative to alternative flows such as ODA and FDI (also shown in the table). The bottom portion of Table 2 indicates that, since the 1990s, SSA (excluding RSA) also has received a declining proportion of total portfolio flows (bank and non-bank) to all developing countries. Moreover, subsequent to the Asian financial crisis of 1997/98, net flows of commercial lending to SSA (either including or excluding RSA) have been negative in most years. Stated on a cumulative basis, over the decade from 1997 to 2006, SSA (excluding RSA) was a net exporter of portfolio capital to the value of USD 2.3 billion, which compares to a cumulative portfolio capital inflow to RSA of USD 63.4 billion over the same period.<sup>5</sup> This all points to the comparative marginalization of SSA (excluding RSA) from global portfolio flows.<sup>6</sup>

<sup>5</sup> For SSA (excluding RSA), this figure is comprised of USD -2,237.5 million in commercial lending, USD 537.5 million in portfolio equity and USD -605.0 million in bond flows (all at current prices).

<sup>6</sup> This is analysed in further detail by Jones (2007). He finds that, compared to a similar group of non-SSA lower income countries, SSA (excluding RSA) has been significantly more marginalised from global portfolio debt flows (bank credit and bonds), but not from equity flows.

These figures might suggest that, outside of South Africa, SSA remains largely excluded from the potential benefits of financial globalization. While this may be accurate in some instances, the above data on *net* portfolio flows can be misleading. Not only is this due to general data-quality concerns, but also flows stated on a net basis can mask improvements in the level or terms of access to external sources of capital where capital outflows (relating to repayment of legacy liabilities) occur simultaneously. Using the IMF's (2008c) figures on new sources of external financing to emerging markets, it is apparent that a select number of SSA countries have been able to (re)gain access to private capital markets very recently. Highlights include two sovereign Eurobond issues in 2007 (Ghana, USD 750 million; Gabon, USD 1 billion), over a billion dollars in international equity issues arising from Nigeria

**Table 3: Proportion of total net FDI to Sub-Saharan Africa (excluding South Africa) received by resource vs. non-resource intensive countries (1985-2007, annual averages in %)**

|   | 1985-87 | 1995-97 | 2005-07 | 1985-07 |
|---|---------|---------|---------|---------|
| <i>Resource-intensive countries:</i>      | 89.6    | 69.4    | 73.8    | 74.4    |
| <i>of which</i> Nigeria                   | 37.5    | 44.1    | 56.1    | 38.4    |
| Angola                                    | 18.5    | 11.3    | -6.6    | 10.4    |
| Equatorial Guinea                         | 0.3     | 3.8     | 9.7     | 7.5     |
| Zambia                                    | 4.5     | 4.5     | 3.6     | 3.7     |
| Chad                                      | 2.4     | 1.2     | 3.5     | 3.5     |
| Côte d'Ivoire                             | 5.5     | 8.8     | 1.9     | 3.4     |
| Namibia                                   | 0.7     | 3.9     | 2.7     | 2.6     |
| Congo                                     | 2.3     | 2.8     | 2.6     | 2.4     |
| <i>Non-resource-intensive countries:</i>  | 10.4    | 30.6    | 26.2    | 25.6    |
| <i>of which</i> Tanzania                  | 0.2     | 4.7     | 3.1     | 3.3     |
| Ethiopia                                  | -0.1    | 3.4     | 2.0     | 2.5     |
| <i>Total value in USD billions (real)</i> | 1,504   | 3,364   | 15,530  | 5,689   |

Notes: Resource-intensive groups defined in accordance with IMF definitions; all calculations refer to real values, at constant 2000 prices; selected countries refer to top ten recipients according to overall period average; negative share for Angola in last sub-period reflects public purchases of foreign-owned resource rights.

Source: author's calculations from UNCTAD (2008).

in 2007, and various large syndicated loan deals (also dominated by Nigeria). Alongside recent growth in the market capitalization of selected African stock markets (especially in Nigeria, Kenya and Ghana; see Jones, 2008), these trends have prompted a number of analysts to suggest that these countries are moving towards serious 'emerging market' investment status (Nellor, 2008; IMF, 2008b). However, as the same analysts also often recognise, improved access to international capital markets has occurred only very recently and generally remains small compared to other capital flows such as ODA and FDI. Moreover, it comes from an extremely low base and is limited to a select group of comparatively more developed and/or resource-rich economies.

The latter point is reflected in the data on foreign direct investment (FDI). On the one hand, FDI indicators for SSA (excluding RSA) appear more encouraging than those for portfolio flows. Table 2 suggests that South Africa captures less than 20% of all FDI flows to the region (versus 99% of non-bank portfolio flows) and that SSA's share of FDI to all developing countries has remained above its overall income share. In other words, SSA has not been marginalised from global FDI flows to nearly the same extent as from portfolio flows. Nevertheless, FDI overwhelmingly seeks resource-rich economies in the region, a trend that has persisted since at least the 1980s. Table 3, for example, calculates that resource-intensive SSA economies (excluding RSA) received an annual average of 75% of all FDI to the region over the period 1985-2007, which is essentially the same share observed in the latest period (2005-2007). Thus, the broad structure of direct investment appears not to have altered significantly, despite improvements in macroeconomic conditions across much of the region (see Table 1; IMF, 2008b). Of the top ten recipients of net FDI over the whole period, only two countries are not defined as resource-rich (Tanzania and Ethiopia), which together account for only 6% of average FDI to the region.<sup>7</sup>

Finally, the distribution of remittances also shows an uneven pattern at the country level. Taking the latest estimates from the World Bank (2008c), inward remittances to SSA averaged 1.7% of GDP in 2006 versus over 3.5% in South Asia, the Middle East and North Africa. While these are not negligible volumes (also see Table 1), they are dominated by a small number of countries. In volume terms, the top ten recipients of

<sup>7</sup> It might also be noted that both Tanzania and Ethiopia have attracted significant investment in natural resource extraction sectors. More broadly, large upsurges in FDI in other (non-resource intensive) SSA countries can also frequently be traced to specific mining projects. For example, net FDI to Burkina Faso jumped to USD 500 million in 2007, up from an average of USD 24 million over the previous five years (at 2000 prices), in large part due to investments in the mining sector.

remittances account for 85% of total remittances to the region, excluding RSA. In each of these countries, remittances represent around 3% or more of GDP, rising to 109% in the case of Liberia and 24% in Lesotho.<sup>8</sup> Thus, remittances are significant in comparison to alternative flows such as ODA and FDI in only a select number of SSA countries with large overseas expatriate communities. In many other countries, they do not represent significant flows at the aggregate macroeconomic level.

### 2.3 Non-DAC donors in SSA

The role of so-called ‘new’ non-DAC donors has received significant attention. As Kragelund (2008) aptly remarks, however, many of these donors have been active in international development for decades (e.g., China). As might be expected, however, consistent data on the activities of these non-DAC donors is elusive. Even where information is available, it is not published in a comparable format, thus making it difficult to assess whether activities qualify as official aid in accordance with the standard OECD definition (which employs a minimum 25% grant element as a litmus test), or are more commercial in nature. For many non-DAC donors, however, this concern appears to be minor. As set out in Kragelund (2008), a substantial number of these donors are either members of the EU or of the OECD and, as such, are moving towards standardized reporting formats. Moreover, in most cases their external co-operation activities appear to be small, have a regional focus, and are disbursed through a limited number of bilateral project grants, often with the aim of promoting the achievement of the MDGs.<sup>9</sup> As such they represent only a minor addition to traditional ODA flows.

Of greater interest are a select number of larger donors that neither are members of the EU nor of the OECD. A particular feature of this cohort is that mutual economic benefit is a more distinct motive for providing external assistance, as revealed in either official statements or behaviour. Thus, and in contrast to grants, concessional lending and export credits to specific sectors or industries predominate, at least in terms of financing volumes. However, it is here that data weaknesses are most acute. Often only information on the size of new lending facilities can be found, while

<sup>8</sup> The top ten recipients of remittances in SSA by volume in 2007 were (values in millions of current USD in parentheses): Nigeria (3,329), Kenya (1,300), Sudan (1,156), Senegal (874.5), Uganda (848.6), Liberia (685.2), Lesotho (371.3), Mauritius (215.0), Mali (211.8) and Togo (192.5). All data are from World Bank (2008c).

<sup>9</sup> Of the two most significant countries in this group, official motivations for engaging in aid-related activities are not restricted to the MDGs but rather include more economic dimensions such as ICT cooperation (South Korea) and bridging the gap between developed and developing countries (Turkey).

**Table 4: Estimates of external assistance from China to Africa in millions of current USD, 2000-07**

| (I) Concessional flows |                 |               | (II) Geographical exposure of loans /b |                 |            |
|------------------------|-----------------|---------------|--|-----------------|------------|
|                        | Aid estimate /a | Loans /b      | Country                                | Value           | % total    |
| 2000                   | 244             | 70            | DR Congo                               | 8,509.7         | 36.24      |
| 2001                   | 250             | 117           | Angola                                 | 3,730.0         | 15.88      |
| 2002                   | 266             | 168           | Mozambique                             | 2,640.0         | 11.24      |
| 2003                   | 278             | 1,116         | Nigeria                                | 2,600.0         | 11.07      |
| 2004                   | 323             | 3,841         | Sudan                                  | 2,060.0         | 8.77       |
| 2005                   | 407             | 1,902         | Cameroon                               | 1,100.0         | 4.68       |
| 2006                   | 462             | 6,002         | Zambia                                 | 806.6           | 3.43       |
| 2007                   | 625             | 10,264        | Other SSA                              | 2,035.5         | 8.67       |
| <b>Total</b>           | <b>2,855</b>    | <b>23,482</b> | <b>Total</b>                           | <b>23,481.7</b> | <b>100</b> |

Notes: /a estimates rely on the Chinese government's methods for calculating aid and, thus, include grants, interest rate subsidies on loans, and the principal value of zero-interest loans. /b loans report the annual value of new facilities (including soft loans, concessional and export credits) principally financed by China's EXIM bank and as stated in media reports.

Sources: a/ Brautigam (2008: 20); b/ author's calculations from Davies et al. (2008: Appendix II)

detail on underlying loan terms or actual annual disbursements (usage) is typically not provided.<sup>10</sup> This is pertinent, as such credit flows appear to be very significant in relation not only to other forms of external assistance provided by these donors, but also to total volumes of external financing.

The most controversial and substantial example of the above set of issues refers to China's activities in SSA.<sup>11</sup> Estimates of China's external assistance to the region vary widely. For example, Kragelund (2008) places the overall value of China's aid programmes at between USD 731 million and 8.1 billion for 2005 alone. Table 4 presents one set of estimates. Of interest here are not the precise values but rather the much larger scale of loan facilities, which cumulatively amount to over eight times the value of stated aid flows. Moreover, these credits are predominantly channelled to infrastructural activities in resource-rich countries (e.g., DR Congo,

<sup>10</sup> For example, it is frequently noted that lending by China to sub-Saharan Africa is often backed by natural resources, in the sense that ownership rights to and/or revenues from these resources provide collateral. However, precise details about these agreements are not made public.

<sup>11</sup> For detailed reviews, see Goldstein *et al.* (2006), also Asche and Schüller (2008).

Angola, Nigeria, Sudan) and thus appear to bolster the observation that China's activities in SSA have been driven by a desire to gain access to (low-cost) natural resources (Melber, 2007). These lines of credit also are reported separately from the various projects operated by Chinese firms in the SSA region, mainly through engineering and construction contracts. Official figures suggest that the turnover of such projects in Africa has risen from around USD 8 billion in 1996 to over 35 billion in 2006 (National Bureau of Statistics of China, 2007; also Wang, 2007), confirming the rapid expansion of Chinese interests in the region. The extent to which these projects are backed by official Chinese technical assistance grants or concessional loans is hard to tell, but the growth in all forms of economic linkages over recent years is hardly coincidental.

Similar patterns are suggested from an analysis of Indian aid to SSA, although overall volumes appear to be lower. For example, operative letters of credit to the region from India's EXIM bank amounted to USD 1,252 million as of March 2008 (Exim Bank of India, 2008), which largely refers to agreements under the Team-9 (Techno-Economic Approach for Africa-India Movement) initiative to support projects by Indian firms in West Africa. These credit volumes clearly dwarf total aid flows from India to Africa, equal only to USD 12 million in 2007/08, down from 24 million in 2004/05 (Government of India, 2008). Thus, in similar fashion to China, mutual economic benefit appears to be a dominant motive for expanded cooperation with SSA.

## 2.4 Basic-needs financing vehicles

A striking recent trend, and one that is particularly salient for low-income SSA, has been the expansion and proliferation of specialized vehicles for financing the provision of basic needs; these vehicles are often referred to as vertical funds where they focus on very specific developmental interventions. As summarised in Appendix Table A1 (also see Section 3), support to basic needs can be seen as a specific kind of development intervention focussed on assuring access to a range of merit goods such as basic health care, clean water, sanitation, child nutrition and shelter. These kinds of goods relate directly to the MDGs, finding their justification in poverty reduction and human rights-based approaches. In the majority of countries one might expect these goods to be provided effectively by private agents (e.g., households invest in their own homes and children) or by a minimally functioning public sector (a *quid pro quo* of taxation). However, in the poorest countries these conditions can breakdown due to households' inability to pay and/or inadequate coverage of public services.



Table 5 provides a summary of some of the main vehicles that have emerged to finance enhanced basic-needs provision in the poorest countries. Despite numerous differences, they share common characteristics. First, they tend to operate as independent organizations often structured as a partnership between existing public and private development agencies. In the latter cases, this means their governing boards include members from a range of different organizations. Secondly, these vehicles typically perform three main functions, namely: (a) raise and pool funds for highly specific, pre-announced causes; (b) disburse grants to local implementing agents (public and private sector); and (c) formally evaluate outcomes to feed back into processes (a) and (b). In other words, these vehicles do not directly implement projects in developing countries; rather, they work to channel funding to the ‘best’ possible users of funds according to expected (and observed) outcomes. Thirdly, to further reinforce their results-based orientation, these vehicles tend to use explicit eligibility criteria for beneficiaries to gain access to funds. A good example is the Global Fund, which employs a multi-step process – all low income countries are eligible to receive funds to combat HIV/AIDS, tuberculosis and/or malaria, though lower and upper middle-income countries must pass differentiated targeting and cost-sharing tests. Other vehicles, such as the Education for All Fast Track Initiative and the Millennium Challenge Corporation, also incorporate specific criteria on governance and policy soundness. These ‘challenge’ approaches represent explicit mechanisms to address some of the perceived failures of traditional aid, which has tended to rely on *ex ante* commitments to policy reform rather than *ex post* outcomes (see Radelet, 2005; Koeberle, 2003).

Notwithstanding the novel structure of these vehicles, Table 5 indicates that official funding sources remain indispensable. In the case of the Global Fund, which is the largest of all initiatives on an annualised spending basis, 96% of projected funding derives from official grants, which in turn correspond mainly to the larger DAC donors, including the US President’s Emergency Plan for AIDS Relief (PEPFAR), which is one of the most significant contributors. At the same time, private philanthropic foundations such as the Bill & Melinda Gates Foundation have also risen to prominence as sources of funds. However, despite their large endowments, spending is projected to occur over a very long time period and is often not exclusively focussed on low-income countries or single causes, as in the case of vertical funds. Moreover, as is shown in the table, funds from these foundations also are channelled into various specific ‘vertical’ funds of a sort already described.

Table 5: Summary of selected basic needs financing vehicles

| Vehicle                                   | Active period | Total spend (projected)           | Objective   | Main funding sources  | Organization / approach  |
|---|---------------|-----------------------------------|---|---|--|
| Global Fund                               | 2000 onwards  | 17,100                            | Combat of HIV/AIDS, tuberculosis and malaria                                    | Official grants (96%) + other private sources (e.g., PRODUCT REDTM, Bill & Melinda Gates Foundation); existing financing pledges extend until 2010.                         | Independent public-private partnership; administratively autonomous (01/01/2009); implementation via grants to local agents (e.g., NGOs, gov. bodies); World Bank acting trustee.    |
| GAVI                                      | 2006-2015     | 4,000                             | Reduce child mortality by increasing access to vaccination and immunization     | IFFIm (legally binding long-term official grant commitments to 2026 used to back international bond issues); Advanced Market Commitments; direct official funding.          | Independent alliance based on a public-private partnership model; hosted by UNICEF; provides grant support to national governments in response to country proposals.                 |
| Education For All – Fast Track Initiative | 2002-2015     | 1391                              | Accelerate progress towards universal primary school completion by 2015         | Official grants to core trust funds (Catalytic Fund, Education Program Development Fund).   | Partnership of bilateral donors, international agencies and development banks; World Bank managed and administered; quick-disbursing grants made to (mainly) national governments.   |
| Alliance for a Green Revolution in Africa | 2006-2011     | >150                              | Catalyze an African Green Revolution via support to small-scale farming systems | Seed funding from Bill & Melinda Gates Foundation (USD 100m) and Rockefeller Foundation (USD 50m); (small) additional funds from official and private sources (e.g., DFID). | African-led partnership approach; allocates grants to eligible projects and agents over a five-year period (2006-2011); also host to Africa Enterprise Challenge Fund (USD 50-100m). |
| Millennium Challenge Corporation          | 2004 onwards  | 6,700 (approved as at Sept. 2008) | Reduce poverty and stimulate economic growth                                    | US Government.  | Independent government corporation; highly selective (based on governance criteria); 5-year grant commitments made to eligible countries.  |
| Bill & Melinda Gates Foundation           | 1999 onwards  | 35,000 – 60,000                   | Improve health and reduce hunger & extreme poverty                              | Private family endowment + gifts of Berkshire Hathaway shares (Warren Buffett gifts)  | Independent foundation; distributes grants and monitors progress; some advocacy activities.  |

Source: author's collation from respective institution websites, retrieved between December 2008 and January 2009.

Table 6: Summary of selected structured financed products

|  | Authority                                | Summary  | Progress  |
|--|--|--|---|
| Private Infrastructure Development Group (PIDG)              | Multi-donor, member-managed organisation | Umbrella organisation to encourage private infrastructure investment   | 4 main facilities and 2 affiliated programmes: see examples (a) – (c).  |
| (a) Emerging Africa Infrastructure Fund (EAIF)               | PIDG facility                            | Arranges debt financing on commercial terms with a tenor of up to 15 years ranging from USD 10 million to USD 36.5 million; political risk cover not required. | USD 281.9 million funds currently committed out of total potential of USD 365 million (as at March 2008); 12 deals arranged.                          |
| (b) GuarantCo  | PIDG facility                            | Provides guarantees to encourage local currency funding of infrastructure investment by domestic actors.   | Two deals completed (by end 2008) – Celel Kenya (USD 10 million) & Cotel Tchad (USD 7 million)  |
| (c) Global Partnership on Output Based Aid (GPOBA)           | PIDG affiliate (World Bank led)          | Designs and arranges performance-based subsidies to support delivery of basic services where public funding to complement or replace user fees is justified    | 72 projects valued at USD 154.73 million (January 2009)   |
| Global Emerging Markets Local Currency Bond Program (GEMLOC) | World Bank                               | Supports development of local currency bond markets to increase their attractiveness to domestic and international investors                                   | Local currency global bond index (GEMX) developed; investments managed through PIMCO (no details available).  |
| Development Credit Authority (DCA)                           | USAID                                    | Provides partial (up to 50%) credit guarantees for private-sector investments to reduce risks associated with lending to new or underserved sectors            | 1999-2005: 143 guarantees made in 41 countries worth USD 419 million corresponding to USD 1,040 million total credit (cost to USAID = USD 31 million) |
| Community Led Infrastructure Finance Facility (CLIFF)        | Homeless International                   | Strategic venture capital facility to enable poor urban communities to expand existing portfolios of construction projects                                     | Cumulative spending of approx. USD 7 million to end March 2008, mainly through capital grants.  |
| Slum Upgrading Facility                                      | UN-Habitat                               | Mobilize domestic capital for urban upgrading activities by facilitating links among local actors and helping to prepare projects to raise investment          | Under construction with USD 11.8 million seed official funding from the United Kingdom (DFID) and Sweden (SIDA).                                      |

Source: author's collation from respective institution websites, retrieved between December 2008 and January 2009.

Although these vehicles generally operate in a transparent fashion, no comprehensive or consistent data set on disbursements covering all vehicles is easily available. Even so, a review of recent reports suggests that well-performing low-income countries, especially those in SSA, have been particularly successful in accessing substantial volumes of funds from these vehicles. Indeed, it is frequently the same set of countries that have achieved HIPC completion (and therefore MDRI eligibility status) that also appear as major recipients of MCC and other vertical fund grants. Taking Mozambique as an example, approved grants from the Global Fund, GAVI, MCC and EFA-FTI together add up to around USD 944 million, or approximately USD 235 million on an annualised basis (see Appendix Table A2). In the context of average annual ODA flows of around USD 1.6 billion (in 2007), these sums are far from trivial. Moreover, due to their highly concentrated nature, they are particularly significant within individual sectors.

## 2.5 Structured financing products

The final trend of interest is the extension of structured financing products to lower income developing countries. While these take very different forms, they typically involve the provision of credit enhancements by public-sector or multilateral agencies through development finance institutions and as part of public-private partnership deals.<sup>12</sup> The objective is to (partially) mitigate some of the main risks faced by private creditors, thereby leveraging additional credit and/or improved credit terms. Instruments include credit guarantees (covering credit risk), liquidity guarantees, tenor extensions and bond guarantees. Of course, such products are not new and have been used extensively across the developing world, typically in relation to FDI project finance. More novel, perhaps, is the attempt to use these instruments to support credits in sectors (and countries) that have previously been unable to raise adequate private-sector finance for either economic or social infrastructure provision. Additionally, certain instruments also attempt to support debt issuance in domestic as opposed to hard currencies, thereby reducing the currency risk faced by beneficiaries in developing countries, often a source of significant instability.

A summary of some of these structured financing products is given in Table 6. Without entering into specifics, it is clear that many initiatives remain at an early phase of development and therefore do not boast a proven track record. The number of

<sup>12</sup> See te Velde and Warner (2007) for a broader review of the role of development finance institutions in infrastructure financing.

completed or approved projects remains relatively small, nor are financing volumes large, either individually or on aggregate. This is particularly apparent when compared to the volume of funds associated with FDI, non-DAC concessional credits and even basic-needs financing. Moreover, it is often the case that completed deals are concentrated in well-performing countries and/or sectors (e.g., telecoms) as opposed to areas that have been more problematic such as in transport, energy and water infrastructure.<sup>13</sup> For example, according to the World Bank database on private participation in infrastructure projects in SSA, during the period 1990-2007, over 66% of investment by value was in the telecoms sector, compared with under 5% in water and sewage projects (author's calculations from World Bank, 2009). It should also be noted that these financing mechanisms remain heavily dependent on the financial support and leadership of the established donor community. Nevertheless, preliminary evidence suggests that these products have successfully raised funding in domains that have traditionally been under-served by private finance. Strides also have been taken to improve global information-sharing regarding project investment opportunities, potential project sponsors, and risk mitigation instruments – e.g., through the global clearing house initiative.<sup>14</sup> Thus, progress has been achieved but would appear to have been slight, especially in view of the financing needs of the infrastructure sector in SSA, which are estimated at around USD 35 billion annually (Foster, 2008).

<sup>13</sup> For further discussion, see Foster (2008).

<sup>14</sup> See: [www.globalclearinghouse.org](http://www.globalclearinghouse.org).

### 3. Assessing recent trends

The previous section outlined important trends in the development financing landscape, with a particular focus on SSA. The collated evidence suggests that a range of alternative financing options have emerged, involving disparate objectives and actors. The remaining question is the extent to which these alternatives, taken as a whole, contribute to addressing the development financing challenges faced by the poorest countries. Section 1 gave an outline of prevailing views on these issues and highlighted the following key challenges: (i) expanding financing volumes; (ii) improving the predictability of disbursements; (iii) supporting country ownership; and (iv) enhancing alignment and harmonization with country systems.

An additional challenge arises from recognising that the way financial instruments are designed has profound implications for their suitability for different developmental needs. Consequently, it also is vital to consider the incentive compatibility between different financing instruments and the nature of development challenges. Appendix Table A2 distinguishes between a number of broad developmental domains and their corresponding financing challenges. As indicated, external financing of productive sector activities is principally compatible with interventions that yield direct investment returns. However, numerous potential investment risks, as well as project design costs which may arise from technological uncertainty or the need for skills upgrading, can reduce the attractiveness of investment opportunities. At the other extreme is basic-needs financing, which has a very low potential for cost recovery but, at the same time, generally faces low design costs and inter-dependency risks (i.e., the nature of successful interventions is well understood *ex ante* and success largely does not depend on outside factors).

Employing the above framework, some of the distinct benefits of alternative approaches to financing immediately become apparent. Aside from the growth of private financing to the productive sector in SSA, the other specific trends noted in Section 2 all appear to improve the incentive compatibility of financing instruments and developmental needs. Returning to the example of basic-needs financing, the low potential for direct economic returns, as well as the need for effective scale in delivery, helps explain why official donors have traditionally not focussed exclusively on this domain, especially where strategic-economic interests have motivated aid allocations. In contrast, the basic-needs vehicles discussed in Section 2.4 represent relatively large and specialised funding pools motivated chiefly by moral or ethical concerns (as per

the MDGs). In many cases, they also provide more predictable funding streams, a case in point being the bond-finance approach of the IFFIm. As such, these approaches appear to be more compatible with the challenge of supporting basic needs in poor countries than traditional ODA. Similarly, the focus of larger non-DAC donors such as China on providing external funds to support mutual economic interests goes some way towards addressing problems in financing domestic improvements in economic infrastructure. At least more recently, traditional donors have been less forthcoming with finance in these areas due to the shift towards a poverty-reduction agenda, as well as reservations over governance and corruption. As is well known, these concerns are given a lower priority by many non-DAC donors. Moreover, these same donors have been active in using external finance to catalyse other flows, particularly trade in goods. Although these non-DAC inflows are not without their wider challenges (for examples, see Woods, 2008; Gill *et al.*, 2007), on one level they may enhance the compatibility between the incentives faced by finance providers and beneficiaries in the area of economic infrastructure. The same is true for structured products, which are also largely in the infrastructure domain, but also extending to social goods and services. The distinctive feature here, however, is the creation of hybrid vehicles which combine the higher risk tolerance of public entities with the competitive economic orientation of private-sector operators. In the case of schemes financed by the Global Partnership on Output Based Aid, for example, temporary user-cost subsidies are provided by the public sector in order to incentivise private-sector provision of key services such as clean water. This mixture of public and private incentives thus aims to improve the overall quality of development financing and outcomes in this domain.

These trends clearly mark progress in addressing some of the incentive-compatibility problems in development financing. However, they are not without their limitations. First, it is apparent that progress has been relatively narrow in the sense that the alternative financing mechanisms which have emerged do not cover the full range of developmental domains. Most notably, financing for improved governance institutions or social goods and services has been poorly served by recent developments. Even though some mechanisms incorporate new approaches to dealing with governance concerns, for example via ‘challenge’ mechanisms, it is as yet unclear whether these provide genuine incentives for wholesale reforms or merely reinforce good performance. Similarly, mobilising finance to the agricultural sector remains especially problematic. As discussed in Foster *et al.* (2001), development challenges in this domain are highly complex and interdependent in nature. Volatility in global commodity prices and production risks associated with climatic shocks also make designing viable financial risk-mitigation instruments for agricultural investments

extremely problematic in low-income countries (Dorward *et al.*, 2001). Consequently, calls for a global fund for agriculture have largely been dismissed (see Eurodad, 2008), underlining the difficulty of extrapolating successes in one domain (e.g., health) to others. In addition, despite the growth in private-sector inflows, Section 2.2 has indicated the uneven nature of this expansion at both the country and sector levels in SSA. Given the ongoing problems faced by small and medium-sized domestic firms across SSA in gaining access to finance (Nissanke, 2001), benefits from the surge in private-sector flows to the region would appear to have accrued mainly to large firms. In general, therefore, the coverage of alternative approaches to financing appears limited. Rather, better-performing and often richer developing countries have benefitted disproportionately from an expansion of alternative financing mechanisms, as have specific firms, sectors or issues such as basic needs, goods and healthcare in particular (see Table 5).

Secondly, the reliability of these alternative financing mechanisms can be questioned.<sup>15</sup> The growth in non-DAC flows and private finance volumes need to be understood in the context of highly benign global conditions and bullish commodity prices in particular. The emergence of structured financing products has also proved extremely congruent with booming global financial conditions – that is, the increasing complexity of financial products, the higher risk appetite of advanced country investors and a general expansion of interest in emerging markets investments motivated by the search for yields. As argued further in Section 4 below, however, these ‘push’ factors have already weakened to a very considerable extent. Past experiences indicate the significant pro-cyclicality of private capital flows to developing countries (Kaminsky *et al.*, 2004) and the tendency for flows to suffer sudden stoppages due to changes in global or domestic conditions (Calvo *et al.*, 2004). Also, although FDI flows are typically considered less prone to rapid reversals or stoppages, the evidence suggests that they are no less volatile than official aid flows (Jones, 2007). In addition, both structured products and the majority of basic-needs funding remain heavily dependent on ongoing support from the established donor community. A partial exception to this rule is the IFFIm, which has been able to establish legally binding official commitments. For all other vehicles, however, any reduction in official donor budgets or changes in donor policies could significantly undermine their funding base. Thus, it is hard to see how the vast majority of alternative development financing mechanisms are any *more* reliable than official aid.

<sup>15</sup> Reliability is used as a broader concept than that of predictability and covers the overall constancy of inflows in terms of their volumes and characteristics.



Thirdly, and linked to the previous two concerns, it is unclear to what extent these alternative approaches to financing bestow substantial new funds in areas which previously faced genuine shortages of finance. In the case of vertical funds and structured products, the reliance on official grants indicates that the volume of new funding is limited, especially in light of slow progress in scaling-up ODA (see section 2.1). Rather, these funds largely represent special vehicles for managing official flows towards specific causes as opposed to raising new money *per se*. In contrast, the growth of non-DAC and private sources of funds does appear to have raised additional financing. The critical question here is whether these flows have brought opportunity costs in terms of aggravating domestic distortions or undermining positive domestic developments.<sup>16</sup> While this cannot be answered exhaustively, a number of observations indicate that such costs may be large in some instances. Breisinger and Thurlow (2008), for example, argue that, in contrast to previous commodity booms, the majority of resource-extraction profits now accrue to foreign companies instead of the wider public through taxes and royalties.<sup>17</sup> Others have argued that the recent emphasis on Africa's primary resources, such as via Chinese investments, may increase the risk of 'resource curse' problems (Taylor, 2007). There has also been concern that foreign private inflows to small SSA economies have stimulated exchange-rate appreciation, with potentially nefarious long-term effects (for Zambia see Cali and te Velde, 2007). The same issues are generally not raised with respect to remittances, however. A growing body of evidence indicates that migrant remittances help address genuine needs, thereby contributing to poverty reduction (e.g., Gupta *et al.*, 2009). Even so, and as with the other alternative financing mechanisms, these flows are distributed unevenly among the poorest countries.

Fourthly, the emergence of alternative financing mechanisms adds to the complexity of development financing in the poorest countries. This is both true on aggregate and in relation to specific instruments. If the experience of public-private partnerships in advanced countries is anything to go by, structured financing products are likely to be highly demanding on already scarce government resources in low-income countries. Although many development finance institutions provide support through technical assistance, data is not available to evaluate the quality or terms of such assistance (te Velde and Warner, 2007). A common critique of vertical funds also is the added burden they place on host-government administrations due to the various

<sup>16</sup> These are most often discussed with reference to aid inflows. See, for example, Moss *et al.* (2008).

<sup>17</sup> Table 1 provides estimates of FDI profit repatriation as a percentage of GNI. Evidently, these outflows are significant in comparison to official inflows and are relatively larger in SSA than in other developing regions.

grant-application, reporting and coordination processes they entail, as well as weak alignment with host-country systems in some cases (Eurodad, 2008; Drechsler and Zimmermann, 2006). As such, the final balance of costs and benefits from these funds may be low relative to what could have been achieved simply by scaling up ODA from existing donors. Moreover, the proliferation of basic-needs financing vehicles has not occurred alongside a visible fall in the scope of traditional aid projects in these same domains. Thus, overlaps and fragmentation in aid remains a real concern (Wood *et al.*, 2008).

## 4. Post-crisis outlook

Before concluding, it is pertinent to reflect on the potential impact of the current global financial crisis on development financing in general and alternative financing mechanisms in particular. It would be unwise to offer clear-cut predictions, given the rapidly evolving and uncertain future of global financial conditions. Thus, the present discussion is limited to three key areas where the effects of the crisis are likely to be played out.

First, despite the fact that the financial crisis had its origins in the advanced countries, developing countries have not been unaffected. As Smick (2008) notes, the thesis that (some) emerging markets were becoming decoupled from the vicissitudes of the US business cycle has been strongly undermined by recent events. The shortage of liquidity in advanced countries and the desire to reduce leverage has led to a rapid contraction of investors' appetites for risk and a flight to quality. This has entailed a flow of funds out of (higher risk) developing country markets and a jump in financing costs, as evidenced by the decline in stock-market valuations across the developing world and an increase in bond spreads respectively. For low-income SSA, these immediate effects have not proved extensive, as domestic capital markets are largely underdeveloped. A greater concern is the reduction in FDI flows which is likely to occur due to the downturn in the global commodity cycle,<sup>18</sup> lower global economic growth and the increased difficulties multinational firms will face in raising project finance. Additionally, given that yields in advanced countries are expected to rise as governments and corporations seek to raise new equity and debt financing, the relative attraction of emerging market investment opportunities should also fall. All types of private capital flows to developing countries – including hybrid structured financing, products which naturally incorporate higher risks due to their more complex and innovative nature – are likely to suffer as a result. Remittances may also decline as advanced countries fall into recession and lay off workers, a phenomenon that has the potential to hit immigrants the hardest.<sup>19</sup>

<sup>18</sup> This has already been witnessed in the sharp reduction in the price of oil from a monthly average peak of USD 134 per barrel recorded in July 2008 to USD 42 in December 2008 (using IMF statistics for dated Brent crude). Similarly, the non-fuel commodity price index saw a 35% fall over the same short period.

<sup>19</sup> The World Bank's Chief Economist put it as follows: "All of the main external sources of funds for investment [in developing countries] are likely to drop off sharply ... Portfolio investment will fall, as greater risk aversion keeps capital closer to home. While FDI is historically more resilient to shocks, it too is expected to decline. ... the global slowdown will reduce demand for commodities and manufactured goods, cutting into export earnings. And as labor markets slacken, foreign workers are likely to suffer disproportionate impacts on their earnings, which will reduce remittances" (Lin, 2008: 10-11).

Secondly, a major factor for at least some countries in SSA over the medium term will be China's response to the global crisis, and in particular the degree to which it maintains its strategy of expansion in the region. A key risk factor is the emergence of domestic social and economic unrest in China, due to lower economic growth. This may prompt its leaders to draw on its large reserves of external investment funds to support the country's domestic industries and pulling back from current and new investments overseas. To the extent that this is also associated with sustained lower global commodity prices, economic linkages between China and SSA may witness steep declines. Alternative scenarios are possible, however. For example, Chinese firms may capitalise on the relative weaknesses of Western multinationals to extend their interests further in SSA. Also, in reaction to US economic difficulties, China may seek to diversify its portfolio of international reserves out of dollar-denominated assets (mainly US Treasuries). Plausibly this could also spur deeper and wider investments in the SSA region.

Thirdly, perhaps the most critical question for many low-income countries will be the response of real ODA flows to the global economic crisis. If history is anything to go by, this is a highly plausible scenario that is only reinforced by the scale of domestic capital injections already approved or proposed by the major DAC donors. Table 1 indicates that in 2000, ODA had fallen to less than half its 1995 value in real terms, a phenomenon at least partly explained by the clouds of recession then accumulating over the European Union. Using perhaps the most pertinent example, Roodman (2008) calculates that, after the Nordic financial crisis of 1991, aid from Norway, Sweden and Finland fell by 10%, 17% and 62% respectively (measured from peak to trough, and adjusted for inflation). Private contributions from individuals and firms may also decline significantly, which may have a deeper impact in particular domains such as emergency aid and targeted health interventions (e.g., HIV/AIDS). Moreover, these effects may not be distributed equally across countries due to differences in geo-political importance. Strategically less significant countries, such as some of the poorest African countries, may be relatively more exposed to alterations in aid flows than others.

## 5. Conclusion

This paper has offered an integrated and up-to-date review of alternative development financing mechanisms, covering new instruments and new actors. It has been shown that a number of important changes have occurred in the development finance landscape. These include the growth of private capital flows to SSA, the return of non-DAC donors, the proliferation of basic-needs financing vehicles, and the emergence of new structured products to finance infrastructure and social services provision. It has been shown that in many cases these mechanisms represent improvements in the incentive compatibility between financing instruments and developmental challenges.

The limitations of alternative development financing mechanisms also have been identified. Thus far, they only respond to a narrow range of developmental challenges. Financing shortages appear to remain acute in a number of critical areas such as agriculture. Private-sector flows to SSA also continue to be heavily slanted toward primary resource sectors and larger firms. The extent to which they provide reliable sources of new funding has not been demonstrated. They also add to the overall complexity and potential costs of managing external financing, especially for the poorest countries.

The overall contribution of alternative financing mechanisms in addressing development financing challenges is therefore modest. Alternative mechanisms do not represent comprehensive solutions to perceived weaknesses in traditional aid financing and thus cannot be seen as adequate substitutes for traditional ODA. Where used selectively, however, they may complement and enhance official flows. Nevertheless, and as with all forms of external assistance, the potential benefits accruing from alternative approaches to financing would appear to depend on the genuine developmental commitment and effective governance capacity of the beneficiary government. Where the latter conditions are absent, archetypal downside risks associated with external financing, such as the Dutch Disease and institutional distortions, are likely to be more prominent due to the added volume and complexity of inflows.

Over the medium term, the outlook for alternative financing mechanisms is particularly uncertain due to both lower risk appetites among investors and mounting pressure on official aid budgets. As private flows dry up, events are likely to underline the ongoing centrality of official assistance from the major DAC donors to the poorest

countries. However, there is the possibility of a silver lining. The financial crisis could be an opportunity to reduce aid fragmentation and overlaps in aid delivery among established donors. In doing so, alternative financing mechanisms may receive a boost where they enhance incentive compatibility between instruments and challenges. Understanding these compatibilities and designing appropriate products therefore remains an important agenda.

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## Appendix Tables

Table A1: Summary of developmental domains and corresponding financing challenges

| Domain                    | Type    | Principal financing challenges  | Discovery /design costs | Inter-dependency risks | Cost recovery potential |
|---------------------------|---------|---|-------------------------|------------------------|-------------------------|
| Governance institutions   | Public  | Incumbency; design costs; complex interdependencies                         | high                    | high                   | very low                |
| Basic needs               | Merit   | Ability-to-pay; effective scale; administration costs; low economic returns | low                     | low                    | very low                |
| Social goods and services | Mixed   | Efficient scale; ability-to-pay; equity concerns                            | medium                  | medium                 | medium - low            |
| Economic infrastructure   | Mixed   | Indivisibility; economic feasibility; country risks                         | medium                  | medium - low           | medium                  |
| Productive sector         | Private | External shocks; country, market and credit risks                           | variable                | variable               | high                    |

Source: author

**Table A2: Estimates of financing to basic needs in Mozambique from new funds**

| Vehicle      | Approved grants | Project lifetime                          | Objective                                |
|--------------|-----------------|---|--|
| Global Fund  | 320.3           | 2005-10                                   | HIV/AIDS (68%)                           |
| GAVI         | 38.2            | 2000-09                                   | Vaccines (83%)                           |
| MCC          | 506.9           | 2007-11                                   | Water & sanitation (40%),<br>Roads (35%) |
| EFA-FTI      | 79.0            | 2008-09                                   | Primary education                        |
| <b>TOTAL</b> | <b>944.4</b>    | ≈ annual average spend of USD 230 million |  |

Source: author's estimates based on information provided from respective fund websites.