BLAVATNIK SCHOOL of GOVERNMENT
UNIVERSITY OF OXFORD
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Securing the Future of Multilateral Development Finance: Time for Europe to take the Initiative

Richard Manning

The governance structures of multilateral development banks are out of step with economic and political realities. Multilateral development finance is critical for achieving development objectives, including the post-2015 sustainable development goals. Yet many of the 'old' multilateral institutions are under strain. Many traditional donors are unwilling and unable to increase funding in the context of budget constraints. Meanwhile, rising powers are not stepping up their support in line with their rapid economic growth. Instead they have promoted new competing institutions, the BRICS' New Development Bank and the Asian Infrastructure Investment Bank.

This preference reflects well-justified concerns about the governance of traditional development banks. Yet there is therefore a danger that soft finance from the multilateral development system will atrophy. While increased competition in the area of less-concessional lending is not itself unwelcome, there are concerns that it could easily lead to undue weakening of safeguards designed to protect sustainability and fairness. A mutual learning approach between traditional and new institutions is much to be preferred to political gaming on either side.

Europe in particular has an opportunity and responsibility to live up to its long-standing support of multilateral development assistance in ways that will increase the banks' legitimacy and gain buy-in from the rising powers.

European countries should:

- Signal support for initiatives that would allow rising powers to increase their shares and votes in the traditional development banks in line with their growing economic weight, accepting reductions in relative European shares.
- Radically consolidate the currently fragmented and excessive number of European Chairs.

Rising powers, as the major shareholders of new development banks, need to signal their support for cooperation by taking seriously the importance of appropriate 'safeguards' in new institutions that they are bringing into operation.

Rising powers should:

- Ensure that new banks use appropriate, evidence-based, technical, economic, institutional, environmental and social appraisal to ensure loans support sustainable development.

Development banks, old and new, should:

- Give priority to mutual lesson learning about approaches which improve their value to the sustainable development of their borrowers.

ABOUT THE AUTHOR

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Over the past 70 years, the world has built an entirely new and unprecedented set of institutions which broadly speaking aim to improve economic and social outcomes around the world. These include major development banks, such as the World Bank, the African Development Bank, the Asian Development Bank, the Inter-American Development Bank, and the European Bank for Reconstruction and Development.

The year 2014 marks a major turning point in this institutional architecture: the establishment of not one but two new official development finance institutions: the New Development Bank and the Asian Infrastructure Investment Bank. These institutions have been created by 'rising powers'. They are headquartered in China and their membership does not – at this time - include any of the 'traditional' donor countries of the OECD's Development Assistance Committee.

What does this imply for development finance? Are these new institutions healthy competition for established but overly bureaucratic and unresponsive multilateral development banks? Or are they yet more fragmentation of an already over-complex suite of institutions retailing official development finance? How should 'traditional' donor countries respond?

It would be easy to debate the creation of these new institutions as a manifestation of power politics between the developed counties of the OECD/DAC and rising powers. For instance, China is believed to have made efforts to get some DAC member countries to join the Asian Infrastructure Investment Bank, while the US, it is claimed, exerted pressure in the opposite direction. However, it is more important to discuss how the changing architecture might impact on the effectiveness of multilateral development assistance.

THE NEW DEVELOPMENT BANKS: PLENTY OF ROOM FOR CO-EXISTENCE…

The New Development Bank was established by Brazil, China, India, Russia and South Africa at their annual 'BRICS Summit' in July 2014, and the Asian Infrastructure Investment Bank was announced in Beijing in October 2014 with China as its largest shareholder.

The new banks are expected to provide for the most part non-concessional finance. They will therefore operate in the same segment of the official development finance 'market' as the hard window operations of the World Bank and the established Regional Development Banks, and to the extent that they lend to non-sovereigns, also the International Finance Corporation and analogous institutions. Given the huge investment needs of borrowing countries, there is in principle plenty of scope for additional lending on the kind of terms that such institutions can offer.

Access to finance from multilateral development banks, even when it is on non-concessional terms, is important for borrowing countries. Funds from this sector are much cheaper and usually on longer terms than funding from the international capital markets (which may indeed not be open to some borrowers). They are a vital source of infrastructure investment in areas such as power and transport, helping to address economic bottlenecks and spur growth. The new banks can help address a chronic shortage of such finance.

It will also be important that loans are on terms similar to those of established development banks. The Development Bank of Latin America ('CAF' from its origins as the 'Corporación Andina de Fomento') has shown that a development bank can offset a slightly lower credit rating (AA as opposed to AAA) than its most direct competitor, in this case the Inter-American Development Bank, through much lower operating costs. This strategy has enabled it to expand its lending to comparable levels.

There are similar benefits when 'Rising powers' lend in association with existing development banks. Many have large foreign exchange reserves that they are looking to invest and such lending, typically on longer maturities and lower rates of interest than borrowers could find in the market, compares favourably with the still extremely low interest rates available in the Treasury bill market of the US and other major OECD countries. China has already pioneered the provision of quite substantial sums in cofinancing with traditional development banks. This includes \$2bn with the Inter-American Development Bank \$3bn with the International Finance Corporation and \$2bn with the African Development Bank.

…BUT A NEED TO WORK TOWARDS APPROPRIATE STANDARDS

Traditional development banks have 'safeguard' policies requiring borrowers to comply with a range of technical, economic, institutional, social and environmental standards. Many of these standards are important for ensuring that borrowers use the funds to support sustainable development, and that poor and marginalised people are not disadvantaged by activities financed by the development banks (or are fairly compensated for any unavoidable costs). There is frequent debate about the precise terms of these safeguards, and some borrowing countries consider them in some cases unreasonably demanding, leading to unduly lengthy project processing and excessive cost. The World Bank recently issued a draft of a new safeguards policy that responds to some of these concerns but which some CSOs regard as weakening significant aspects of its existing regime.

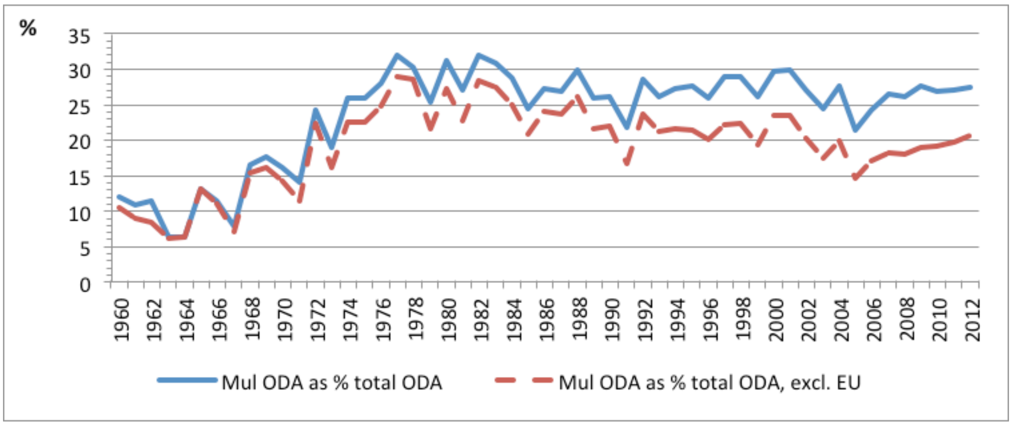
What lending standards will the new banks require? A concern that preoccupies many traditional donors is that less stringent standards may undermine the development impact of lending. On the other hand, borrowers may find loans from the new banks particularly attractive if (as with China's bilateral aid) decisions are taken more quickly and loans come with less demanding safeguards than are usual in the established development banks.

Given the overarching goal of supporting sustainable development, there is room for lesson learning here between the 'traditional' and 'new' development banks. The 'traditional' banks could learn lessons on how to speed-up the issuance of loans, while the 'new' banks could learn lessons on the use of standards to ensure sustainable development impact. The willingness of emerging economies to apply appropriate, evidence-based, standards in the new institutions would signal goodwill and minimise the risks of a politicised stand-off which would be in no-one's interest. Emerging economies should ensure that these banks use such standards to ensure that loans support development which is socially and environmentally sustainable.

TRADITIONAL DEVELOPMENT BANKS: SOFT LENDING UNDER STRAIN

An important part of concessional aid ('official development assistance' or ODA) provided by traditional donors is routed through multilateral agencies. After swiftly rising to nearly 30 per cent of all aid from the traditional donors in the 1970s, multilateral ODA (excluding the institutions of the European Union) then fell slowly to between 15-20 per cent in the 1990s and early 2000s. In the past decade this proportion has gradually risen again, as traditional donors have increased their funding to the soft funds of the banks and created new 'special purpose funds' like the Global Fund for AIDS, Tuberculosis and Malaria (figure 1).

FIGURE 1: MULTILATERAL ODA AS A PROPORTION OF TOTAL ODA FROM MEMBERS OF THE OECD DEVELOPMENT ASSISTANCE COMMITTEE, 1960-2012



Source: OECD/DAC (2014).

The concessional arms of the traditional development banks, such as the World Bank's International Development Association (IDA), account for nearly 50% of all multilateral concessional aid. The provision of such forms of finance is an area in which the new banks are not – to date – expected to operate on a significant scale.

Given the vital importance of highly concessional finance for overcoming the most pressing development challenges, including those signalled in the Sustainable Development Goals due to be agreed in 2015,the health and effectiveness of the soft windows of the traditional development banks is extremely important.

The system is however under increasing strain[1]. Traditional donors are continuing to face tough fiscal challenges and their contributions to recent soft fund replenishments have been at best flat, with increases reserved for special purpose funds such as the Global Fund and now the new Green Climate Fund, which has more or less reached its $10 billion target. Progress in engaging major rising powers in a way that reflects their rapidly-growing relative economic weight has been depressingly limited. Of course, these countries are still in general much less well-off than most traditional donors and cannot be expected to contribute so high a share of their GNI to multilateral initiatives. However, it would have been reasonable to expect a more significant rise in the absolute amounts that such countries are contributing.

1 See 'The multilateral aid system: an assessment following the major replenishments of 2013', UNU/WIDER Working Paper 2014/110, Richard Manning

THE PROBLEM OF GOVERNANCE AND VOICE IN THE MULTILATERAL DEVELOPMENT BANKS

The heart of the problem is that governance structures are out of step with economic and political realities. The lack of reforms that reflect the economic weight of rising powers has left these countries feeling under-represented in institutions steeped in 'Western' approaches. This is a major reason for setting up their own institutions and reluctance to increase contributions to 'old' banks.

There is a stark disconnect between the share of rising powers in the global economy and their contributions and voting position in the traditional development banks. Contrast, for example, the rapidly rising share of the BRICS in the world economy over the recent past (figure 2) against the very small changes in the voting share of these countries on the Boards of the World Bank and the African Development Bank in figures 3 and 4.

FIGURE 2: GNI IN PURCHASING POWER PARITY, US$ BN, CURRENT PRICES, 2007 AND 2013

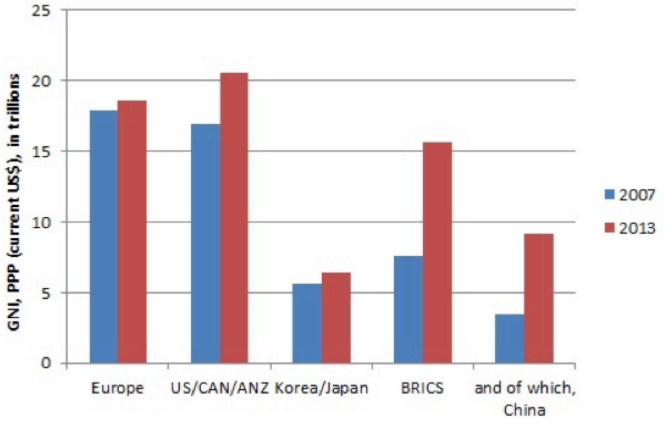


FIGURE 3: VOTING SHARES IN THE WORLD BANK, 2007 AND 2013[2]

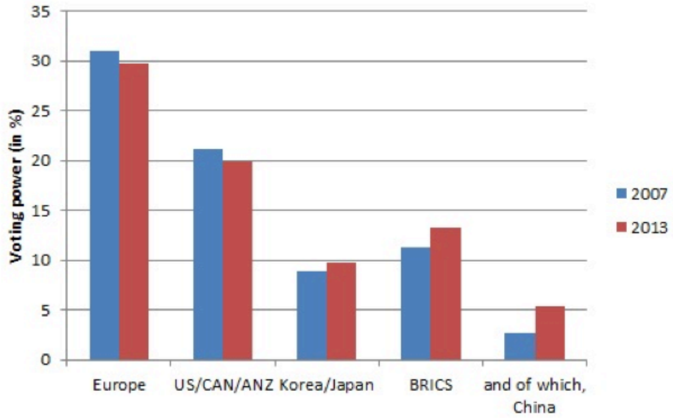
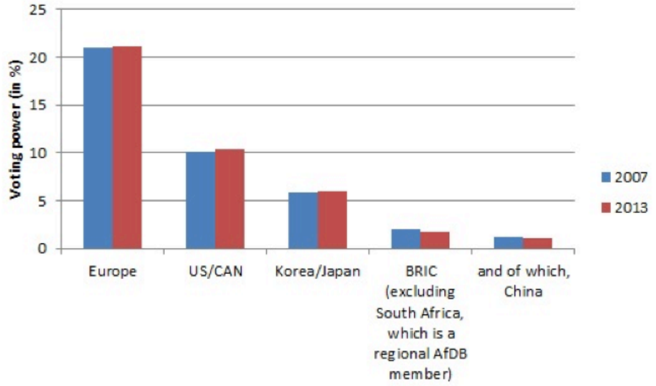


FIGURE 4: VOTING SHARES OF NON-REGIONAL MEMBERS IN THE AFRICAN DEVELOPMENT BANK, 2007 AND 2013



Europe, which is in most cases the region most over-represented in relation to its economic weight, could and should play a key role in championing governance reform and revitalising the traditional development banks. International attention to the governance reforms of major international organisations has focused on the IMF, where reform has been blocked by the US Congress. But action is also needed in the major development banks, where Europe has itself completely failed to develop a constructive policy for allowing its vote share to reflect real economic weight, while maintaining influence by consolidating its representation (a far-sighted attempt between the Finance Ministries of France and Germany in this direction foundered some 15 years ago).

European countries could take the lead by collectively allowing special capital increases in the traditional development banks – including the World Bank and African Development Bank - that would give rising powers shares that reflect their growing economic weight. This would secure much greater buy-in from these countries. Paradoxically it might also benefit Europe. Radical consolidation of the presently fragmented and excessive number of European Chairs would make for a more coordinated European position, and increase Europe's legitimacy in the eyes of rising powers, ultimately strengthening the voice of European representation[3].

2 Data for these charts was drawn from World Bank and AfDB sources. It was compiled by GEG research officer, Alexandra Zeitz.

3 On the gains from unified representation, see for instance 'Unifying EU Representation at the IMF Executive Board: A Voting and Veto Power Analysis', Peter Brandner, Harald Grech, Iain Paterson, Reihe Ökonomie, Economics Series, 2009

RECOMMENDATIONS:

European countries should:

- Signal support for initiatives that would allow emerging economies to increase their shares and votes in the 'old' development banks in line with their growing economic weight, accepting reductions in relative European shares again reflecting changing economic realities
- Radically consolidate the currently fragmented and excessive number of European Chairs

Emerging economies, as the major shareholders of new development banks, should:

- Ensure that these banks use appropriate, evidence-based, technical, economic, institutional, environmental and social appraisal to ensure loans support sustainable development.

Development banks, old and new, should give priority to mutual lesson learning about approaches which improve their value to the sustainable development of their borrowers

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