Workshop on Domestic Resource Mobilization
Public Expenditures-Infrastructure

OECD, Paris
October 11 2010

"Infrastructure Financing in LDCs and Emerging Economies: Risk Mitigation and PPPs"

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Infrastructure Financing in LDCs and Emerging Economies

Agenda

- Motivation: public policy, private investment and infrastructure financing needs
- Background: From Monterrey to Doha and UN MDGs
- Unexploited Potential of Development Finance Institutions to Catalyze Private Investment
  - Risk mitigation tools and PPPs
- Questions for further discussion

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Motivation

- How is infrastructure investment financed in LDCs and Emerging Markets? What's new? **One size doesn't fit all**, varying degrees of financial development, legal and regulatory institutions, history and integration in the world economy matter.

- Which role for public policy? **Market failures** are typical in infrastructure financing: indivisibilities, coordination failures, large-scale projects, incomplete or no financial markets, political risk, currency risk, among others. As a result, sub-optimal private investment.

- How can public policies best address those failures and effectively **leverage** private sources of funding?

- Back to "old" literature on the RoI of the State in Postwar development strategies: central planning and allocation of resources (Nurkse, Rosenstein-Rodan, Myrdal, ECLAC, Oman (OECD DEV)). Infrastructure was at the center of debate, though another context.

- Now, complementarities between public sector initiatives and private investment=> PPPs

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Background

2002-date: Post-Monterrey Follow up Agenda: domestic resource mobilization

2005-2008: World Economic Forum Initiative (esp. 2006)
2008: UN Doha Business Forum-Financing for Development
2008- date: G20 meetings-Working Group on Development
2009-2010: OECD Global Development Forum, focus on taxation

2010: UN Summit Millennium Development Goals…way far from attaining infrastructure goals in most countries. Gap not closing in LDCs. All this occurs:

…against the backdrop of a systemic global financial crisis and donors retreat or shifting focus onto poorest countries due to budget constraints tied to massive bailouts, fiscal stimulus and trade off against debt sustainability…

…and the emergence of "new" actors (China India, Russia), and instruments (SWF, Global and Domestic Bonds in Local Currency, Regional Banks, Guarantees, Taxes) as catalytic development finance institutions

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Background

- Industrialized countries finance their infrastructure and economic growth largely with funds from the private sector – especially capital markets.
  - However international and domestic capital markets are largely inaccessible to most developing countries, due to concerns about high risk levels.
  - In consequence: private sector investments are limited to those countries/sectors considered the most creditworthy and profitable (BRICS and few other)

- Capital markets in developed countries are widely reported as being underinvested in LDCs (Uphill flows and the Lucas Paradox, Home Bias).

- **Investment needed to keep up with projected growth in the developing world was estimated as equivalent to an average of 5.5% of the developing countries´ annual GDP in 2005**. However public sector (accounting for ¾ of all infrastructure investments) was spending 2 – 4% of GDP on infrastructure (Latin American governments 1.6%, Africa 2-3% average, WEF, 2006)

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Unexploited Potential of Development Finance Institutions to Catalyse Private Investment- Risk Mitigation

- Needs of developing countries for support (technical and financial) is enormous, far beyond the resources that countries and official agencies can directly mobilize themselves.
- Urgent need for the official sector to engage with the private sector in creating growth, jobs and more broadly distributed benefits throughout the developing world=>**rationale for PPPs**.
- Change the role of developing institutions, so that they become **catalysts** that further increase private sector investment, the current dominant source of capital for developing countries.
- Public investment **should crowd in** rather than crowd out private investment, i.e. infrastructure expenditures, and leverage this funding source

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Unexploited Potential of Development Finance Institutions to Catalyse Private Investment- Risk Mitigation

Expansion of Risk Mitigation Activity and PPP functioning

- Risk mitigation can unleash the underutilized power of the official and private sectors, enabling the official sector to act as a market – maker catalyst and innovator hence easing the setting up of PPPs

- Development Institutions can use risk mitigation tools to attract other private sector capital, increasing the total amount of capital available to the developing country recipient (Sub-Saharan Africa, Thailand, Argentina and alike).

- <u>The private sector needs to be engaged in defining attractive risk mitigation products as well as customized risk mitigation transaction structures that meet the specific **needs of countries and projects**</u>.
- See examples in next slide (source: WEF, 2006)

Infrastructure Risks and Relevant Risk Mitigation Instruments (RMIs)

Type or risk	Available RMI
Political	Political risk cover - either specific, part of comprehensive cover, or in a credit guarantee, preferred credit status.
Foreign exchange availability	(1) use of currency finance; (2) currency hedging; (3) government exchange rate guarantees; (4) indexing tariffs to foreign currency; (5) devaluation liquidity backstop schemes.
Credit	Partial Credit Guarantees (PCGs)
Devaluation	None as such. Local currency guarantees and devaluation liquidity schemes are relevant.
Commercial	None specifically, but PCGs include this risk among others.
Project profile	PCGs can lengthen loan tenors to match cash flows.
Rate of return	Breach of contact cover can protect tariff covenants, devaluation liquidity schemes protect cash flow following devaluations.
Sub-sovereign	Certain RMIs can be offers without a sovereign counter-guarantee (SG), others need SG. Relevant RMI depends on type of risk to be covered.
Contractual and regulatory	Breach of contract cover, changes in law, license requirements, approval and consents.

Source: World Economic Forum, 2006

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Risk Mitigation Tools: How can they work?

- **Partial first loss guarantees** that raise credits to investment grades – developing countries often present unacceptable levels of risk and uncertainty that discourage interest from institutional investors. DFIs: provide a bridge between particularly middle income developing countries and this enormous untapped reservoir of capital.

- **Multilateral credit insurance facility** – developed countries have "successfully" (?????) used private sector financial guarantee insurers (MONOLINES) to facilitate the access of sub-national government agencies and private sector infrastructure projects to international and domestic capital markets.
- **Products targeted to regulatory and currency risks** – Foreign Exchange Liquidity Facilities, Regulatory Risk Contingency Facilities, Partial Risk and Credit Guarantees, and Political Risk Insurance.

- **Multilateral securitization facility** – Diversification: combining different investments with different cash flow streams, risks and returns.

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Risk Mitigation Tools: How can they work?

- **Subsidization of infrastructural projects** – to broaden access to lower income populations, to ensure project viability without subsidies.
  - Donors need to realign their institutions to enable the use of grant funding for subsidies to allow for broad-based access to infrastructure services, at least during the early stage of development.

- **First Loss Guarantees** – when combined with private sector investments and guarantees can offer capital market access to more risky countries.

- **Inclusion in ODA targets** – failure to do this has discouraged bilateral agencies from expanding their application.

- Global Development Bonds – initiative to create a new, fixed income, securitized product, aimed at mobilizing capital in a systematic manner, especially from institutional investors, to finance sustainable development in the developing world. **Not much action seen so far…**

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Risk Mitigation Tools and PPPs. Alternatives and further questions

- In poorest countries with nearly no financial markets and low saving rates ODA and PPPs backed up with broad guarantees should prevail. The ultimate challenge, however, is to help these countries develop deep and liquid financial markets.

- Taxation: long way to improve taxation policy and administration, no short-term shortcut.

- Local currency bond markets in Emerging Economies, yes, but to what extent are they meeting long-term investment needs in infrastructure?

- Regional banks: can they innovate and conceive new instruments and tools adapted to country-specific conditions? The type of infrastructure financing risk may differ substantially from Mali to South Africa.

- Sovereign Wealth Funds?