Review of the Monterrey Consensus on Financing for Development

February 14, 2008 Review Session on Mobilizing Domestic Financial Resources for Development

U.S. Government Submission

> *"To succeed in the global economy, nations need fair and transparent legal systems, need free markets that unleash the creativity of their citizens, need banking systems that serve people at all income levels, and a business climate that welcomes foreign investment and supports local entrepreneurs."*
>
> President George W. Bush, May 2007

The 2002 Monterrey Consensus identifies *mobilizing domestic financial resources for development* as the first of six "leading actions" or pillars in support of financing for development (FfD). The Consensus sets out a broad range of commitments by both developing and developed countries (see box for key commitments under this pillar). Helping developing countries increase the mobilization of domestic financial resources is a major focus of U.S. Government assistance programs; the attached fact sheet outlines a number of U.S. initiatives in this area.

Monterrey Consensus: Mobilizing domestic financial resources for development *(key commitments)*

- Supportive enabling environment
- Good governance
- Control of corruption
- Sound macroeconomic policies
- Public resources/budgeting
- Sound banking systems
- Micro-finance/SMEs – including women and rural areas
- Capacity building, with special focus on Africa

Mobilizing domestic financial resources is the first pillar of the Monterey Consensus for good reason. Commitment to mobilizing domestic resources is a profound statement of the primary responsibility each country has for its own economic and social development. Moreover, increasing domestic financial resources holds the key to achieving many other development objectives. For example, if developing country public sectors operate more efficiently, donor resources will achieve greater results as well. If reforms to increase the integrity of the financial system are successful, domestic savings will flow into financial institutions and give private companies greater opportunities for financing. If corruption is brought under control, donor resources and local taxpayer revenues will go further and achieve more.

Relying on official development financing to meet development goals may seem like an easier path. But international aid is not a panacea. Large aid inflows can cause their own economic problems, such as fueling spending on inefficient projects, fostering corruption, leading to overvalued exchange rates, and leading to greater government control over an economy. For these reasons, the Monterrey Consensus realizes that a successful development strategy requires far more than simply seeking more foreign aid. Countries must find every means to catalyze domestic financial resources.

Developing countries face many challenges in financing their development priorities. The public sector must be able to raise revenues efficiently without unduly impeding private initiative and must manage its budget and expenditure processes so that available resources are used efficiently to promote development. Five years after Monterrey, public administration remains weak in many countries. Since the public sector plays a major role in financing and executing infrastructure investments, public sector inefficiencies in turn have negative consequences for growth of the private sector. The public finance and administration reform agenda is an ample one, comprising such topics as public sector expenditure control, fiscal and procurement transparency, civil service reform, tax administration and the planning and budgeting process. Making progress on these issues should be a priority for the foreseeable future.

For many countries, corruption continues to undermine the rule of law and hamper the public sector's ability to meet development goals. Tax revenues and public funds are diverted or stolen, infrastructure projects suffer from inflated costs and quality problems, or never get built at all, and private sector activity is disadvantaged. At the same time, the enabling environment – the interface between government and the public – must function in a way that makes government a partner to a prospering private sector, and not an obstacle in its path. In many countries, onerous licensing requirements, uneconomical or impossible regulatory requirements, and other costly procedures impose burdens on private entrepreneurs that limit the creation of employment and output, in turn dampening growth and potential domestic resources available for development. Putting in place and enforcing laws against corruption and implementing reforms to eliminate bureaucratic red tape are key tasks facing many countries today.

Government spending can never be the sole, or even the primary, engine of sustainable development. The private sector also finances infrastructure, trains workers, and creates income, including for the poorest households and enterprises. Moreover, the private sector is best able to allocate resources to meet society's needs. Private initiative both provides and depends on the availability of financing, and it is essential that financial systems in developing countries function efficiently, capturing savings and channeling them to the best projects and ideas. In recent years, financial systems in developing countries have matured considerably. Development of private pension systems, formalization of microfinance institutions, growth of insurance industries, expansion of private banking, better domestic capture of savings, development of more transparent regulatory frameworks, and sound fiscal policies contributing to less public sector demand for credit have all contributed to this result.

Progress Since 2002 and Lessons Learned

There has been substantial progress under this pillar since 2002, fueled by strong world economic growth and the trend toward sound macroeconomic management in all regions of the developing world. To cite one indicator, between 2003 and 2006 domestic credit to the private sector as a percent of GDP in low income countries increased from 27.7% to 39.6% (World Bank, World Development Report database). This measure reflects the growing diversification and size of the financial systems in these countries. Nonetheless, high income countries still provided four times more domestic credit to the private sector than did low income countries.

Several key lessons emerge from the experiences of developing countries in recent years. First, ***business climate reform is a key factor enabling developing countries to expand domestic resources for development***, as it is correlated with higher growth, investment, and income. Countries with greater economic freedom (another term used to measure the performance of a country's business enabling environment) have substantially higher growth rates. Countries ranked in the upper quartile on economic freedom had annual growth rates of 2.3% versus 0.4% for the countries ranked in the lowest quartile.[1] The World Economic Forum's *Global Competitiveness Report* has found strong statistical associations between GDP per capita and the business environment. In addition, countries ranked in the upper quartile on economic freedom had average net FDI inflows as a percent of GDP 4.05 times higher than countries ranked in the lowest quartile (FDI of 15% vs. 3.7%).[2] Countries with the highest economic freedom also have lower rates of unemployment and inflation.[3]

Opening financial services sectors and investment regimes has also been important for developing countries to mobilize financial resources. New entrants bring expertise, technology, and competition. They diversify vehicles for savings and investment, increase access to capital, and provide sophisticated instruments (e.g., derivatives) for mitigating risk. Markets open to competition tend to be deeper and more liquid. By contrast, the cost of capital in closed markets is higher and vehicles for savings and investment are more limited. The small size of the market increases risk and volatility. Capital is too expensive for most, a constraint on entrepreneurship and development. The World Bank estimates that by 2015 the developing world would increase its annual economic output by $300 billion, or 2 percent of GDP, from financial sector liberalization.[4]

The second key lesson is that country commitment in both words and deeds is what counts. Economic development progress is, first and foremost, a function of a country's demonstrated political commitment to rule justly, promote economic freedom, and invest in people. Many developing countries maintain outmoded laws on their books that establish burdensome fees to register a business, as well as complicated and costly procedures to register property. For example, in 2007 Mozambique dropped requirements -- dating from 1888 colonial era laws – that would-be entrepreneurs publish printed notices in the official gazette and use notaries to set up companies. The aggregate changes resulted in reducing start-up costs by two-thirds, and time from 113 days to 29.[5]

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[1] James D. Gwartney and Robert Lawson. *Economic Freedom of the World: 2007 Annual Report* (Calgary, Alberta: Fraser Institute) http://www.freetheworld.com/2007/EFW2007BOOK2.pdf

[2] Ibid.

[3] *Index of Economic Freedom* (Washington, DC: Heritage Foundation) http://www.heritage.org/Index/.

[4] World Bank, *Global Economic Prospects and the Developing Countries 2002*, http://siteresources.worldbank.org/INTGEP2002/Resources/gep2002complete.pdf .

[5] Doing Business 2008, p. 11

Many nations also allow their legal and regulatory systems to lag behind international best practices, denying their people access to credit and other financial services. Most poor countries lack effective credit registries and collateral laws, and as a result banks make fewer loans.[6] The Report of the U.N. Commission on the Private Sector and Development estimates that developing countries have $9.4 trillion dollars in private financial assets that cannot be fully mobilized for development, largely because of gaps in national legal systems stemming from inadequate legal protections for property and contracts.[7] Egypt, the top reformer in *Doing Business 2008*, exemplifies the possibilities of inducing a virtuous cycle of reform when a country commits to the process. In a departure from the traditional top-down way of doing reform, Egypt conducted a series of comprehensive reforms addressing legal and institutional obstacles. This was done in a demand-driven, transparent, manner that slashed costs for starting a business and registering property, cut times to import and export, and reduced the burden to obtain construction licenses.[8]

Remaining Challenges and Emerging Issues:

The trend since 2002 toward higher growth rates and improved development indicators in many developing countries is partly a function of a robust world economy. When economies are growing, tax revenues are generally buoyant and financing more plentiful. Should global growth rates slow, or, if the industrialized economies fall into recession, it will be important to seek to reduce the transmission of economic uncertainties to the developing countries. Macroeconomic policy achievements could be reversed and domestic financing availability could diminish.

A second challenge relates to vulnerabilities in world financial markets. Recent events in the United States point to the ever deepening complexity – and interconnectedness - of financial markets and instruments. This has posed a growing challenge to regulators in the developed countries. Developing country financial markets are also becoming more complex, and for many, the regulators are not nearly up to the task. A common challenge will be to bolster resources and the skills and capabilities of regulatory officials to help developing countries improve financial sector regulation, and push for closer contact among regulators to reduce contagion in the event of financial market dislocations.

A further economic threat for some developing countries stems from rising commodity prices, particularly petroleum. Many developing countries have benefited from the rise in commodity prices. For these countries, the challenge is how to apply their windfall revenues in a sustained and transparent way to meeting development goals. There is a risk that financing in good times will be overly expansive and allocated to recurring expenditures, exacerbating the necessary retrenchment when commodity cycles turn down. Many other developing countries that are net importers of commodities, including some of the poorest, are being harmed from the boom in commodity prices while their

[6] *Doing Business 2008*, p. 29.
[7] *Unleashing Entrepreneurship: Making Business Work for the Poor* UN Commission on the Private Sector and Development http://www.undp.org/cpsd/indexF.html.
[8] *Doing Business 2008*, p. 2.

citizens are suffering the effects of high energy and food prices. Authorities in these countries should seek to mitigate this hardship by strengthening targeted safety nets and not through unsustainable, untargeted subsidies that may crowd out other government spending.

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Fact Sheet on U.S. Government Assistance Programs

The United States funds a number of innovative programs around the world to help developing countries mobilize domestic financial resources for development. These programs reflect global best practices in terms of program delivery modalities and results. Relevant examples are listed below.

Improving Public Finance

Technical assistance from the United States has helped to increase substantially the use of public revenue for development in a number of economies since 2002, including Egypt (tax revenue up 2.5 % of GDP by 2006), El Salvador (up 2.1 %), Georgia (up 7.4%), and Kosovo (up from 6% in 2000 to 28% in 2006). The newly created Kosovar tax system features low, uniform tax rates. Revenue increases resulting from improved administration enabled the Kosovar government to finance all recurrent expenditures and to dramatically reduce Kosovo's dependence on donor financing.

Technical assistance from the U.S. Treasury Department for government debt issuance and management has helped host countries like Ghana, Uganda and Kenya to reduce their borrowing costs, ensure debt sustainability, better manage their risks, and provide appropriate benchmarks for private debt issuers.

Mobilizing Domestic Investment in Productive Infrastructure

The United States has provided substantial assistance to the development and financing of public infrastructure through public-private partnerships (PPPs). Between 2003 and 2007, USAID helped the Peruvian government complete concessions for a new container port at Callao, the country's main international seaport, and to construct and maintain a 964 km highway across northern Peru, from the Amazon to the Pacific coast. These two projects are expected to result in more than $1 billion in private investment in infrastructure in Peru. The U.S. Trade and Development Agency (USTDA), supports a wide range of banking and financial sector activities in low and middle-income countries that promote the development of a modern infrastructure, including technical assistance to for project planning, capacity-building, and capital mobilization activities.

Transforming the Regulatory Environment

The United States offers technical assistance in developing new laws and institutions that are lacking in many emerging economies. For example, USAID has provided technical support to a host of countries – such as Mexico, El Salvador, Honduras, Tanzania, and the nations comprising the former Soviet Union - to adopt pledge registry systems that facilitate bank lending to small businesses and farmers who use movable and intangible assets as collateral for bank loans. Pledge registries provide comfort to banks that their liens on registered assets can secure payment should a borrower default.

The Millennium Challenge Corporation Land Tenure Project in Madagascar has helped secure land rights for smallholder farmers. The program enables local authorities to issues land rights documents to local residents. This has enabled them to leverage their newly secured land to get loans to expand their agricultural and non-agricultural business.

Treasury Department assistance in the development and passage of sovereign debt legislation, including market oversight provisions, provides a comprehensive framework that levels the playing field for issuers and investors, and contributes to increased transparency.

Expanding Private Sector Access to Domestic Financing

Since Monterrey, USAID's Development Credit Authority has structured 170 credit guarantees with private financial institutions that resulted in more than $1.2 billion in local financing for both private-sector and public sector projects. USAID uses a Development Credit Authority (DCA) guarantee to engage in true risk sharing partnerships with private financial institutions to harness greater local investment in domestic markets. In particular, USAID has focused attention and resources on tapping the liquidity, energy and ingenuity of African countries, which, at more than $400 million, comprise the largest regional share of the Agency's partially guaranteed loan portfolio. As of September 2007, the DCA has disbursed 1,100 loans in Uganda and other African countries in an average amount of $98,200 – providing long-term bank credit for equipment and other uses that would be difficult to obtain on a non-guaranteed basis.

The United States is a leader among donors in the field of microenterprise development and microfinance. In 2006, USAID supported 5.7 million borrowers who held $3.6 billion in loans. Almost two-thirds (64%) of these borrowers were women and more than half lived in rural areas. USAID also supported about 7 million individuals to hold $2.7 billion with local deposit-taking institutions, a key strategy to maintain household financial security and provide local capital for the financial sector. The number of USAID-assisted borrowers and savers doubled between 2002 and 2006.

Reforming Financial System Regulation

Financial systems worldwide are growing in complexity. In both developed and developing countries, increasing domestic capital mobilization requires more than simply expanding bank lending. The United States has supported the development of mortgage markets, credit registries, and credit bureaus in Eastern Europe. Coupled with pension system reforms, these activities have spurred capital market development by encouraging pension programs to invest in domestic securities. In Kazakhstan, USAID significantly contributed to the development of a $700 million primary mortgage bond market (representing 10% of the total banking sector's assets) and expansion of the now $7 billion corporate bond market.

<u>Focus on Africa</u>

In line with Monterrey, the United States has made Africa a particular focus in its support of local finance. For example, President Bush's **African Growth and Competitiveness Initiative (AGCI)** aims to expand private sector access to finance by one percent of GDP in targeted countries and to reduce the intermediation margin. This involves lowering market-lending risks that justify and encourage expansion of access to finance.

In May 2007, President Bush launched the **Africa Financial Sector Initiative (AFSI)** to provide technical assistance and mobilize capital to help African nations strengthen their financial markets. The initiative includes the work of the Overseas Private Investment Corporation (OPIC) to create private equity funds that will mobilize up to $2 billion in investment on the Continent in sectors that spur innovation, including telecommunications and healthcare.

Another important effort is the **Partnership for Making Finance Work for Africa**. This effort aims to scale up financial sector development support, overcome fragmentation, and increase aid efficiency in order to support the growth, access, stability and regional dimensions of financial sector development in Africa. The Partnership, which was welcomed by the G8 in the 2007 Heiligendamm Declaration, is open to all financial sector actors.

<u>Partnerships and Small and Medium Enterprises</u>

The United States recognizes that working cooperatively with the resources and strengths of other donors multiplies the value of our respective contributions and creates a more coherent and coordinated approach at the country level. Donor coordination is a powerful tool in efforts to increase domestic financing. For example, the United States has formed a partnership with Japan to help direct both countries' official development assistance funds to local private capital investors. This partnership has significantly boosted the amount of funds directed to the Philippines drinking water sector. USAID and the Treasury Department currently collaborate with a number of other donor agencies and multilateral institutions involved in development financing, including the Asian Development Bank (ADB), the U.K. Department for International Development (DFID), International Financial Corporation (IFC), and the World Bank. More can be done to broaden these initiatives and facilitate new ones.

Small and medium enterprises can be important as both providers of employment and contributors to GDP in high-income and developing countries alike. This underserved segment of developing country markets has the capacity to capture innovations embedded in the human and technological transfers that accompany FDI. In an effort to strengthen the "missing middle," the U.S. Overseas Private Investment Corporation (OPIC) anticipates making $150 million available to support SME lending in Latin America. The

Treasury Department will support this effort by encouraging legal and regulatory reforms to facilitate small business lending in Latin America, and the Multilateral Investment Fund (MIF) of the Inter-American Development Bank will improve the capability of local financial institutions to make SME loans though grant funds for technical assistance.