



Six recommendations for reforming multilateral development banks

An essay series

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December 2017



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Acknowledgements

I would like to thank the authors of the six notes of this report, who could not have been more enthusiastic about being part of this project. Each author worked under pressure to deliver within short turnarounds. I felt privileged to be part of (at times) intense and polarised debates via email on the future of the multilateral development bank (MDB) system and some of these exchanges are reflected in the notes.

A special thank you goes to Mikaela Gavas who provided oversight, timely and precious advice on the concept, drafting and review of this report. Anna Brown, Aaron Griffiths and Julia Hanne provided editorial support, and Garth Stewart designed the report.

Each author is solely responsible for the content and accuracy of her/his own note. I acknowledge the generous support from the Bill and Melinda Gates Foundation that made this contribution possible. The views presented in this paper are solely those of the authors.

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Introduction and overview

Annalisa Prizzon

An ambitious and broad development agenda

Agenda 2030 and its 17 Sustainable Development Goals (SDGs) are now the cornerstone of global development. It is a far more ambitious agenda than its predecessor, the Millennium Development Goals. Agenda 2030 is broad and all-encompassing, and sets out a diverse and complex roadmap towards driving economic, human and social development, ranging from poverty eradication to climate change action. It is also universal, meaning that all countries – developing and developed alike – have committed to reach these goals.

Fulfilling these commitments is highly demanding, partly because of the scale of resources required but also because of the sheer complexity of intertwined policies and their means of implementation. Achieving the new set of goals will require a variety of actors working in concert, each of them with a distinctive role to play, and with diverse instruments and types of resources. It will also require a clear understanding of needs and priorities, particularly of those countries that are lagging behind.

At the same time, development challenges are now set against a backdrop of growing populism and rising scepticism about the merits of multilateralism and collective action. National policies are becoming increasingly inward-looking, questioning the effectiveness and efficiency of the multilateral system. The world of the future – volatile, unpredictable and complex – will require approaches that enable anticipation, facilitate reaction and forge resilience. Above all, it requires the prioritisation of long-term objectives and strategies.

The role of multilateral development banks in the Agenda 2030 and their challenges

Multilateral development banks (MDBs) are unique among international actors because of their distinctive development model. They are well placed to help make Agenda 2030 a reality by helping to mobilise finance, tackle issues that cross national borders, and reach the poorest and most vulnerable people in fragile contexts.

MDBs use various levers to channel finance to developing countries, both directly and indirectly. This occurs in several ways. One is by multiplying the paid-in capital contributions of their shareholders. Another is by helping countries to boost their fiscal revenues and by advising governments on how to expand tax bases and make tax administration systems more efficient. A third is by attracting private investment to areas where profitability is low and risks are high; this is achieved by changing incentives, offering de-risking instruments and demonstrating to private investors that projects can be implemented and scaled up.

Addressing challenges that cross borders or concern countries with weak governance institutions requires pooling risk and financial resources, leveraging a strong knowledge base and a diversified set of financial and

advisory services, and deploying strong convening power among public, private and civil society actors. On the whole, MDBs have demonstrated all these capabilities.

The comparative advantage of MDBs is, however, increasingly under pressure. Their original mandate of financing development, fostering economic development, and supporting regional cooperation among member states has expanded to include poverty eradication, climate change and pandemics and operations in countries characterised by weak institutions.

The MDBs are likely to face a series of challenges in attempting to implement their expanded mandates at both strategic and operational levels.

1. *Provision of global public goods (GPGs)*. MDBs as a system are uniquely qualified to address GPG-type issues given the complex, worldwide, multi-regional and multi-level nature of these problems. Furthermore, middle-income countries are in urgent need of support to help tackle global and regional challenges, particularly climate change, communicable diseases, global financial stability and migrant pressures. But MDBs cannot do so by leveraging only on the country-based lending model. Countries may be reluctant to borrow for projects whose benefits extend well beyond their borders, such as for climate change mitigation and disease control, creating strong disincentives for loans in sectors with positive externalities.
2. *A growing need for a more effective division of labour among MDBs*. Over time, MDBs have developed their own expertise and comparative advantage in certain sectors. Their mandates have evolved as a result. However, MDB activities often overlap in certain sectors when they operate in the same countries, with limited coordination, if not competition, among them, and duplication of efforts for certain functions such as knowledge generation and sharing, evaluation of development effectiveness and impact.
3. *Evolving and increasingly diverse client bases*. The strong growth performance in several developing countries means that fewer countries are now eligible for concessional windows where these exist. In particular, total public finance to lower-middle-income countries falls as economies grow. When countries start to emerge from very low-income status, their growth is constrained as domestic revenue mobilisation fails to expand fast enough to compensate for the fall in concessional assistance – referred to as the ‘missing middle’ of development finance for lower-middle-income countries by Kharas et al. (2014). MDBs are not playing a sufficiently catalytic role in middle-income countries. These countries still need access to appropriate public international funding to help them play their indispensable part in tackling regional and

global challenges that domestic repercussions but also major international spill-over effects, like climate change, communicable diseases and unsustainable migration.

4. *Effectiveness of operations in fragile contexts.* Addressing development and governance issues in fragile contexts is the real challenge for MDBs in countries with weak governance, where the private sector has far fewer incentives to invest and where there are high risks of fiduciary, development and institutional failure. The MDB model – combining large-scale finance, knowledge and expertise with long-term objectives, and pooling resources and risk – is in principle well suited to supporting the needs of fragile contexts. However, MDBs find it challenging to operate in political space, and their country-based business model has limitations when it comes to dealing with sub-national governments, activities that span two or more countries, and engaging in countries where governments may lack legitimacy, where operational response is often slow and inflexible, and where instruments are unsuitable for supporting institutional development.
5. *An increasingly demanding client base that has more financing options to choose from.* Recipient country governments now have a larger set of financing options to implement their national development priorities at their disposal – also referred to as an ‘Age of Choice’ for development finance by Prizzon et al. (2016). As a result, several recipient-country governments have become more assertive in negotiating and managing different providers and sources of finance. Borrowing countries have improved their ability to articulate and pursue their key priorities for development finance.
6. *Limited coordination at the country level.* Formal coordination at the country level is often very limited, especially but not only in infrastructure development, usually the core area of MDB intervention. Not surprisingly, the use of more than one donor procurement and reporting system represents a key challenge for governments. However, MDBs can bring considerable convening power and assist governments in coordinating at project, sector and national levels.

About this essay series

The increasing scale and breadth of global development challenges, a constrained lending envelope, and reduced support for a multilateral system under growing scrutiny all point to the need to review whether the current MDB system is fit for meeting the challenges of the 21st century and how it could be reformed and strengthened.

G20 members recognised this and mandated the Eminent Persons Group, chaired by the Deputy Prime Minister of Singapore, Tharman Shanmugaratnam, to offer views and

recommendations on how the global financial architecture, including the MDB system, should be reformed.

This essay series presents six notes and perspectives on how the MDB system should be reformed to meet the challenges of the 21st century. They focus on elements of strategic direction and policy coherence, operational and financial reforms, and how to respond to an evolving client base.

- *Kiyoshi Kodera* analyses whether the MDB architecture is fit for purpose for the new global development agenda and how MDB strategies and operations should be reformed.
- *Inge Kaul* reviews how MDBs can help address the under-provision of global public goods, such as communicable diseases, financial stability, peace and security.
- *Chris Humphrey* outlines five reform options to maximise the financial potential of MDBs without a capital increase.
- *Alastair McKechnie* recommends how MDB mandates, policies and instruments should be adapted to address the institutional development and financing challenges of countries affected by fragility.
- *Andrew Rogerson* indicates how MDB financing should be better tailored to the needs of middle-income countries.
- *Annalisa Prizzon* reviews how MDB strategies and operations should change based on recipient countries’ perception of MDB operations and financing instruments.

Six recommendations for reforming the MDB system

The evidence base and the analyses in the six notes of this report identify at least six actions that MDB management and shareholders should prioritise to fulfil the role of MDBs – both individually and as a system.

1. **Boost the provision of GPGs.** This will be the cornerstone of MDB operations but it will require an additional business model in which MDBs identify and change incentives for both state and non-state actors to provide additional resources. This model would focus on GPG provision with a clear emphasis on spurring progress towards ‘closing the gap’ between what individual state and non-state actors are willing to do for certain GPGs, and what would be required to meet the systemic integrity requirements of GPGs or other internationally agreed standards for adequate provision. Grants would be the main financing source. Resources could be provided by the budgets of the national focal points of GPGs (e.g. the ministries of health and the environment or, where they exist, national departments of global affairs) and not from development budgets.

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2. **Establish, based on the subsidiarity principle, a distribution of responsibilities and tasks among MDBs for efficient and effective provision of GPGs.** Given its worldwide and multi-issue remit and experience with GPG-related global trust funds, the World Bank appears to be well-equipped to function as the central unit of the MDB additional business model for GPG provision, with the regional MDBs acting as the network's region- and country-specific focal points for which they have a clear comparative advantage.
 3. **Reform the MDBs' approach to operating in fragile contexts.** MDBs should reconsider how they interpret political non-interference mandates in fragile contexts, where development and politics inevitably intersect. MDB shareholders and lawyers have interpreted non-interference clauses to preclude activities that may be vital to enabling good governance and peace. They should also make more creative use of grant instruments, where there is no repayment obligation or concerns about creditworthiness, to fund both national and regional projects that reduce fragility, conflict and violence (FCV) and work around the limitations of the MDBs' country-based operational model. Furthermore, MDBs should deepen their support for institutional development in FCV-affected countries, by rigorously evaluating pilot approaches and scaling up what works. Areas such as public administration reform, public utility management, and oversight of the security sector are ripe for new, innovative approaches by the MDBs and their partners.
 4. **Expand lending and move from a graduation to gradation approach, especially for middle-income countries, with a combination of measures of balance sheet optimisation and general capital increases.** Gradation would permit different aid allocations as conditions and motivations change, especially where there is a strong GPG dimension. Financing instruments should also be diversified, with differentiated financing options that reflect the country context rather than the lending category only. Furthermore, MDB lending capacity should be boosted through a combination of increased headroom via general capital increases and better use of available resources. MDBs should explore other options such as strengthening or repurposing callable capital and evaluating the best way to conceptualise and define MDB capital adequacy.
 5. **MDB operations must address priorities and preferences of their client base.** MDB shareholders need to strengthen their oversight of MDB operations in FCV-affected countries. This would involve greater emphasis on implementation and speed of results, rather than loan approvals. To overcome the challenges fragility poses, MDBs should adjust their policies and procedures for greater agility in fragile contexts; decentralise highly qualified, empowered staff to country offices; use country systems wherever possible; and provide hands-on support to counterparts in low-capacity countries.
 6. **More effectively coordinate MDBs both at the country/ project level in order to reduce transaction costs for recipient countries and to leverage on the MDBs comparative advantage, especially in fragile contexts.** Current coordination efforts for infrastructure development should be explored and extended to other sectors. By pooling the funding of bilateral donors and through co-financing arrangements, MDBs can reduce the fragmentation of external financing, the proliferation of small projects and the high transaction costs to government of coordinating fragmented assistance. Multi-donor trust funds (MDTFs) can also address many of the constraints that MDBs face. MDTFs can allow a subset of MDB shareholders to accept higher risks in countries at risk of conflict, increase strategic coherence, reduce aid fragmentation, and lower transaction costs to the country.

Conclusions

We do not contend that the MDBs offer a panacea. However, they have a critical role to play in making the SDGs a reality. This report has raised some of the fundamental challenges they face and put forward ideas to reform the MDBs as a system and individually. The recommendations aim to strengthen the MDBs' positioning and offer on global development. They also to help them meet their clients' demands effectively, responsively and flexibly so they can better address the multifaceted development challenges of the 21st century.

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How should the multilateral development banks stay relevant in the Sustainable Development Goal era?

Kiyoshi Kodera

Over the last 50 years, multilateral development banks (MDBs)¹ have established their position as major development financiers in the global financial architecture. The MDB system now faces multiple challenges arising from shifts in the global economy and politics after the 2008 financial crisis as well as from the task of meeting the Sustainable Development Goals (SDGs).

The development agenda has broadened and become more complex. The pace of global poverty reduction has slowed down and extreme poverty is now concentrated in countries affected by fragility. Income inequality is on the rise in both developed and developing countries. Technological advancement is threatening jobs and affecting income distribution. Migration and forced displacement have both increased. Challenges such as climate change and pandemics increasingly demand cross-border solutions. Infrastructure development is a priority, now more than ever.

The development finance architecture has also changed. International capital markets, remittances and foreign direct investment have overtaken MDBs and Official Development Assistance, which now contribute a smaller share of the overall volume of finance. New actors have emerged: (1) private philanthropy; (2) health-related multilateral agencies like The Global Fund to Fight AIDS, Tuberculosis and Malaria, and GAVI, the Vaccine Alliance, which have all delivered good results; and (3) China has become a large, fast-growing and dynamic donor and is taking the lead in establishing the Asian Infrastructure Investment Bank and the New Development Bank to fill the huge gap in demand for infrastructure building.

The MDB system is also under scrutiny as major shareholders retreat from the multilateral system. Support for development aid in many developed countries is under threat with the rise of populist and inward-looking politics associated with anti-globalisation sentiments.

MDBs have transformed their role from strictly finance to put more emphasis on knowledge sharing. Their policies and organisations have evolved and adapted to changing shareholder demands. High-level safeguard policies, including resettlement and environmental standards, were introduced during the 1990s. An individual project-based approach was displaced by multi-sectoral country-platform working. Most MDBs have prolific research arms, producing useful evidence, data, statistics and new ideas. They have strong convening power. These comparative advantages are highly appreciated by many policy-makers around the world.² However, there are

areas for improvement and refocus that go beyond simply streamlining internal processes.

What are the implications for MDBs?

Economic growth is central to achieving multi-sectoral goals. The poverty reduction achieved in the Millennium Development Goal era largely depended upon China's growth and the accompanying commodity boom, which in turn lifted growth for many commodity-exporting developing countries.

Regardless of natural resource endowment, sustainable growth requires a better investment climate and good human capital. A stable macroeconomic framework should be maintained. For this to happen, competent public sector institutions are needed. This is an old but recurrent development challenge for many countries, even in the era of the SDGs. Ten years after the global financial crisis, progress in institutional improvement in many developing countries is sluggish, or even back-tracking in some cases. Some 40 developing countries are now predicted to see declining per capita income and increasing debt. Many commodity-exporting developing countries are included in this cohort. In contrast, non-commodity-exporting countries in sub-Saharan Africa that have improved institutional capacity have maintained stable growth.

A new growth narrative for the SDG era needs to incorporate income distribution, demographic challenges, climate change and global public goods (GPGs). However, unless developing countries and MDBs can overcome existing challenges, the new goals will not be achieved. MDB management and shareholders should consider the following actions.

1. *Recognise that poverty reduction is a central element of the SDGs in many regions and that growth is indispensable for achieving those goals. MDBs should renew their push towards building better public institutions, in particular for (i) public private partnerships for infrastructure; (ii) tax and tax administration; and (iii) human development, i.e. health and education.*

- (i) The G20 has already instructed MDBs to increase their efforts to crowd-in private finance to fund public infrastructure. Client countries should build up stable and predictable regulatory frameworks and impartial civil services to oversee regulations, and improve understanding of the complexities of deals with the private sector.

1. In this note, the MDBs means multilateral development finance banks with global shareholding structures: the World Bank Group, the Asian Development Bank, the African Development Bank Group, the Inter-American Development Bank Group, the European Bank for Reconstruction and Development, and the Asian Infrastructure Investment Bank.

2. AidData opinion survey in 2015 covering 6,750 policy-makers in 126 countries showed the MDBs' prominent position over bilateral development agencies, both DAC and non-DAC, in agenda-setting influence, usefulness of advice, helpfulness in reform implementation, and frequency of communication.

- (ii) A Medium-Term Revenue Strategy (MTRS) proposed by the IMF, OECD, UN and World Bank charts core elements for redesigning tax policy settings, reforming revenue agencies and strengthening legal frameworks. This concept should be fully shared and incorporated in the work of the Regional Development Banks (RDBs). The MTRS can help to achieve taxpayer compliance and equity.
- (iii) MDBs should intensify their collaboration with WHO and health-related multilaterals to ensure universal health coverage for the poor to obtain quality and affordable healthcare services. Building on progress in net enrolment in education, more attention needs to be paid to education quality and links to jobs.
2. *Have joint country diagnostic platforms in place to support public institutions on the investment of climate and human capital.* The platform covers political economy analyses/conflict analyses including migration and forced displacement, institution assessment, poverty assessment, and so on. The International Finance Corporation and European Bank for Reconstruction and Development can take the lead in private-sector assessment using a ‘cascade’ logical framework. RDBs can take the lead in cross-border and sub-regional challenges and regional cooperation. The World Bank can take the lead in country contexts for GPG provision. This joint work can reduce clients’ transaction costs and help each bank to have a coherent programme. Countries affected by fragility are particularly in need of this. To build understanding of progress in institution-building, the World Bank should make public the Country Policy and Institutional Assessment (CPIA), not only for low-income countries but for middle-income countries too, as it does in the case of a ‘doing business’ assessment.
3. *Help to formulate public policies and strengthen institutions to overcome the negative impact of new technology on labour.* Advances in technology can bring both opportunities and challenges for developing countries. MDBs should be very careful in presenting views about technological advancement. Digital technology and big data can certainly increase efficiency and development effectiveness. For example, Civil Registration and Vital Statistics (CRVS) is important for public goods delivery and equity, but appropriate data governance or rules for access to big data and privacy should urgently be established. MDBs should also help to formulate public policies and strengthen institutions to overcome the negative impacts of technological advancement on labour. This is particularly critical for Africa with its enormous demographic challenge.
4. *Allow post-conflict/fragile countries and International Development Association (IDA) graduate countries more flexible transitory finance strategies with more moderate timelines.* Concessional finance is still a very important financing source for a number of low-income countries, including countries affected by fragility. Reforms and institution-building take time, which donors have underestimated in the past. Transitory finance can also be applied to middle-income countries with large poverty pockets.
5. *Encourage China’s bilateral agencies to join country coordination fora and share details of their transactions.* China has attracted many developing countries because of its huge volume of finance and fast implementation. Expectations for the Belt and Road Initiative for greater connectivity throughout Eurasia seem high. However, transparency about the terms and conditions of China’s loans and investment, particularly by China Development Bank and China Ex-Im Bank, is critical for debt management in many developing countries.

Conclusion

The magnitude of development and infrastructure challenges can justify – or from a risk-sharing point of view even encourage – the existence of multiple MDBs in each region. More important is the question of how they should work jointly to maximise effective delivery and minimise overlap.

The G20 has important decision-making power in terms of reshaping the working of MDBs in the SDG era, both as shareholder and borrower. The last capital increases and governance reform in 2010 were prompted by the G20’s desire to increase counter-cyclical funding from MDBs to cope with the post-2008 global crisis. While the G20 has asked MDBs to optimise their balance sheets to secure their lending capacity, it should not postpone general capital increases and further governance reform for the MDBs. Regional solidarity made possible the recent replenishment of the Multilateral Investment Fund in the Inter-American Development Bank Group without the participation of the major shareholder. A similar lead from the regional shareholders is urgently needed for the **African Development Bank Group**.

This time, the G20 should not sit and wait for another financial crisis to come along.

Halting the spiral of unmet global challenges: the case for a two-track multilateral development bank business model for global public goods

Inge Kaul

Past experience shows that development may be at risk if global public goods (GPGs) such as climate change mitigation, financial stability or peace and security are under-supplied. In turn, GPG provision may suffer in situations of low development or fragility, constraining among other things the capacity of states to manage cross-border crises such as the spread of communicable diseases or conflict and large-scale refugee movements driven by violence that adversely affect other countries.

However, many GPGs persist in a state of under-provision, absorbing growing amounts of resources deployed to cushion the resulting ill effects, such as the devastation caused by global warming-related storms, floods and droughts.¹ While numerous corrective measures have been taken in most, if not all, GPG-related policy fields, serious under-provision persists in many areas. These pose huge risks that could turn into crises, despite ever-more urgent warning calls from concerned experts.

What could be done to halt this dense spiral of unmet global challenges and crises?

A possible corrective measure: a two-track MDB business model

Multilateral development banks (MDBs) have been involved in GPG-related development initiatives for decades. They have long been aware of the basic constraint of more effective GPG provision, namely that state and non-state actors tend to address global challenges to the extent that their individual interests overlap with global ones (see IEG, 2008).² However, meeting most GPG-type challenges requires more than the efforts that these actors – notably states, individually or collectively – are willing to make. The conventional country-focused business model of the MDBs, together with their signature instrument of sovereign loans, has not only limited the efficiency and effectiveness of their interventions but may also have impeded reform in the overall global financial architecture, given that the MDBs are a major part of the operational side of international cooperation.

Nonetheless, the need for reform is beginning to be recognised (see, for example, MDBs, 2016 and World Bank, 2016); and the search for new policy approaches and instruments is clearly under way (see Kaul, 2017).

Judging from the mainly ad hoc and temporary change initiatives that exist, such as the growing number of GPG-related trust funds being set up within the World Bank Group (see World Bank, 2014, 2017), and from the fast-expanding literature on GPG provision, a most basic

reform to initiate would be to devise an expanded, two-track operational MDB business model.

Track 1 would be the existing country-focused business model aimed at supporting client countries and, upon request, regional entities in devising and implementing national and regional development programmes and projects, including, for example, the intended nationally and regionally determined contributions that states announce to undertake as their contribution to GPGs, such as climate change mitigation or communicable-disease control.

Track 2 would be a new, additional business model focused on GPG provision with a clear emphasis on spurring progress towards ‘closing the gap’ between what individual state and non-state actors are willing to do for certain GPGs and what would be required to meet the systemic integrity requirements of GPGs or other internationally agreed standards for adequate provision.³

Select features of the proposed new Track 2 MDB business model

To understand more clearly how the MDBs *as a system* could mobilise and complement other input providers in moving towards the Track 2 goal of ‘closing the gap’, it is useful to consider some of the design features that would be central to this new business model, including its functions, financing, governance and the division of responsibilities among the MDBs.

Functions: The core Track 2 functions could, for example, comprise the following:

- Preparing, in close consultation and cooperation with the concerned scientific and technical communities, assessments of progress towards: (1) meeting countries’ voluntary commitments to contribute; (2) taking internationally agreed corrective steps in areas beyond national borders; and (3) reaching agreed global goals, such as the SDGs.
- Promoting policy research and development (R&D) aimed, for example, at:
 - Developing a toolbox of effective and efficient incentive measures (including measures such as advance market commitments, mechanisms for investment front-loading, or criteria and formulas for risk- and profit-sharing) to motivate individual

1. According to standard economics, public goods (in their pure form) are non-rival and non-excludable in consumption. Due to their non-excludability and, thus, the public nature of their consumption, their benefits cannot, in most cases, be fully captured by any one provider. Therefore, public goods are at risk of under-provision and often require a concerted, cooperative effort to ensure their adequate provision.

2. To illustrate, CO₂ reductions may emerge as a global co-benefit from measures undertaken by states for the purpose of improving the air quality in their cities and reducing the national respiratory-disease burden.

3. ‘Systemic integrity requirements’ refers to the conditions that must be maintained or achieved in order for a system (natural or human-made) to be able to function in an intact and sustainable way.

state, market and philanthropic actors to cross their national/private-interest hurdles and contribute additional GPG inputs;

- Creating new or building more efficient markets and platforms for bringing potential buyers and investors together with suppliers of GPG-related products and services (e.g. along the lines of Invest4Climate),⁴ promoting the development of tradable products and services, devising price-finding mechanisms and model contracts;
- Supporting existing global mission programmes or encouraging the creation of new ones to spur progress in resolving the most pressing global challenges (e.g. programmes along the lines of the proposed Global Apollo Programme to Combat Climate Change (see King et al., 2015));
- Facilitating, in cooperation with other concerned parties, the identification of ‘gap closing’ projects to be undertaken in areas beyond national jurisdiction (such as the high seas), and assisting in structuring and mobilising investment packages.
- Acting as a trustee of Track 2 funds.
- Administering the support for countries adversely affected by GPG under-provision, such as compensation for loss and damage, payments for needed adaptation, and financing for projects addressing conditions of fragility and vulnerability. Such measures would be important if states are to view international cooperation as fair and just, a perception that would, in turn, be critical for sustaining and strengthening their willingness to contribute, at their own cost (e.g. under Track 1), their fair share to GPG provision.
- Fostering links between Tracks 1 and 2.
- Collecting data on and monitoring financial allocations to GPGs, including those of Tracks 1 and 2, to provide a comprehensive overview and assessment of GPG financing, as a separate but complementary initiative of the MDBs’ monitoring of progress in GPG provision mentioned earlier.
- Collecting, assessing and sharing GPG-relevant knowledge and experience.

Financing: Most Track 2 activities call for grant resources. It would thus be important to provide proof that they support relatively attractive investments, both from the viewpoint of the individual contributors and the entire world. Grant resources would be needed to finance: (1) the regular Track 2 budget; and (2) its various programme budgets. For both budget types, scales of assessment could be established based on burden-sharing formulas that might vary depending on the budget type and the global issue being addressed. GPG provision is likely to be a continuous challenge. Why would we not do for securing global sustainability what we do for securing national borders and peace within countries, the policy field for which such burden-sharing formulas already exist? (These are also in need of review, however.)

The financing for Track 2 operations could come out of the budgets of the national focal points of GPGs (e.g. the ministries of health and the environment or, where they exist, national departments of global affairs) and not, in the case of ‘donor countries’, out of the development assistance budgets, as also proposed by Kharas and Rogerson (2017) and Kaul (2017). Separating development assistance and GPG financing upstream when national budget priorities are established and allocations made would help avoid a mix-up between development finance of the Track 1 type and GPG-related finance of the Track 2 type. This would be indispensable for promoting the more incentive-compatible international cooperation needed to resolve problems resulting from GPG under-provision.

To overcome any opposition to such arrangements from the concerned national authorities it might be necessary to undertake more disaggregated cost/benefit analyses. Equally it might be necessary to develop new international cooperation narratives that allow national policy-makers to claim credit and receive recognition for risks averted through corrective action. Well-founded narratives along this line could help restore the public’s trust in public policy-making and demonstrate that, where policy-makers are willing to cooperate, they can be in control.⁵

Governance arrangements: In order for MDB shareholders to agree on entrusting the banks with a strong, consensus-based Track 2 mandate, a timely review of existing governance arrangements might be necessary so that all borrowing and non-borrowing shareholders would feel that they have an effective voice in matters that concern them. In addition, highly complex Track 2 operations could perhaps have their own issue-specific governance structures, as also suggested by the CGD (2016) in its High-level Panel report.

4. See www.worldbank.org/en/topic/climatechange/brief/mobilizing-finance-for-climate-action-through-the-invest4climate-platform.

5. At present, policy-makers are often being rewarded for *not being in control*: for making available some compensatory finance when disasters such as droughts or floods or financial crises strike.

Moreover, Track 2 operations require clear contractual arrangements, including a shared understanding of how, in specific issue areas, to operationalise principles such as ‘common but differentiated responsibilities and respective capabilities’ (CBDRC) in order to determine, in a simple yet reliable manner, which initiatives fall under Track 1 and which under Track 2.

Division of responsibilities among the MDBs: The MDBs as a system are uniquely qualified to address GPG-type issues given the complex, worldwide, multi-regional and multi-level nature of these problems. But to ensure efficient and effective provision it would be useful for the banks to establish a distribution of responsibilities and tasks among themselves based on the subsidiarity principle. Given its worldwide and multi-issue remit and experience with GPG-related global trust funds, the World Bank Group appears to be well-equipped to function as the central unit of the MDB Track 2 network, with the regional MDBs acting as the network’s region- and country-specific focal points for which they have a clear comparative advantage.

In more and more policy areas there exist ‘global issue managers’, that is, individuals or agencies acting as focal

points of GPG-related international cooperation initiatives. As previously noted, where they exist, Track 2 managers should not compete but cooperate with these entities. In other cases, they could propose to act as substantive and financial issue managers, building on the experiences they gained with past trust fund management (see World Bank, 2014, 2017).

Conclusion

The establishment of the proposed two-track MDB business model would be a major step towards adjusting the system of multilateral banking – and perhaps even the wider system of international cooperation – to the policy-making realities of the 21st century, fostering more adequate GPG provision and thus more sustainable global growth and development for all. In fact, while the MDBs’ country-focused Track 1 activities are set to decline as development advances, their GPG-focused Track 2 activities are set to gain in importance as globalisation deepens in the increasingly multi-polar and clean-energy-driven digital world economy.

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Maximising the financial potential of the multilateral development banks – without a capital increase

Chris Humphrey

Multilateral development banks (MDBs) are key players in turning ‘billions to trillions’ and bringing the Sustainable Development Goals (SDGs) into reality. MDBs can only supply a small share of resources directly, but are critical to transferring knowledge, establishing standards on quality and development impact, and helping to mitigate risks that the private sector cannot manage on its own.

The core MDB financial model is extremely powerful in channelling private investment into development projects. For example, with a total share capital investment of only \$15.8 billion since 1944, the World Bank’s main lending window has supplied nearly \$700 billion¹ in development financing (and counting), almost all of it coming from private investors buying World Bank bonds. Further, World Bank loan revenue has covered the costs of building up the most comprehensive body of global development expertise and data in existence, at no additional cost to taxpayers.

But MDBs can only function properly with a solid financial foundation. To maintain investor confidence, the main lending windows of MDBs can only lend a certain amount based on their shareholder capital.² The World Bank and African Development Bank (AfDB) are already bumping up against their internally defined capital adequacy limits, and the other major regional MDBs will near theirs if they expand lending in line with what is needed to achieve the SDGs. MDBs say they need more capital, but some shareholders think MDBs can do more with the capital they already have.

This uncertainty on MDB capital requirements needs to be resolved. In a context of tightening government aid budgets and ambitious global goals, the ability of MDBs to use financial leverage and channel private investment is one of the most powerful development tools available to the international community. Systemic reforms are essential to bring the MDB financial model up to date and maximise their potential.

What does capital adequacy mean for MDBs, and who defines it?

The underlying problem is that no one knows precisely how to define capital adequacy for an MDB, or who should define it. Gone are the days when the backing of wealthy countries and some finger-in-the-wind metrics defined in their charters was enough to get a AAA rating. In the 1990s MDBs began implementing capital adequacy measurements, which sufficed to keep bond buyers happy, but each MDB came up with its own policies without a systemic approach to MDBs as a class of institution.

After the 2008 crisis, credit ratings agencies – under pressure from regulators – overhauled their evaluation methodologies for MDBs. Unfortunately, ratings agencies have no benchmarks to rely on and limited expertise on the unique characteristics of MDBs, including their mandate for development as opposed to profit, their unusual shareholding structure, official relationship with borrower governments and lack of regulatory oversight, among other characteristics. As a result, new rating agency methodologies do not give enough credit for the financial strength of MDBs. Nonetheless, because of their dependence on bond markets, MDBs must take these methodologies into account when designing their financial policies.

Standard and Poor’s (S&P) revised their MDB methodology in 2012. The new approach gives minimal credit to MDBs for their superb loan portfolio performance, and heavily penalises them for having a portfolio concentrated in relatively few borrowers compared to commercial banks (which is precisely the mandate of MDBs).³ At the same time, S&P’s methodology implies that MDBs could lend several hundred billion more and still retain their AAA rating, based on callable capital⁴ – a type of financial guarantee offered by MDB shareholders.

To complicate matters further, Fitch Ratings updated their MDB methodology in 2016 with an entirely different set of criteria. The result is now pulling MDBs in a different direction. For example, AfDB is solidly AAA according to S&P, but appears on the verge of losing its AAA under Fitch’s approach. Should Moody’s revise their methodology, the situation could become even worse.

MDB management has counselled shareholders against expanding their loan book based on existing capital or taking callable capital into account when evaluating capital adequacy, for fear of losing their AAA rating. Most MDB treasury staff – especially at the World Bank – are highly conservative, and would much prefer shareholders simply to stump up more capital rather than take any action that might threaten their relations with bond buyers.

All the major MDBs have a mandate to maintain a AAA bond rating, but as rating agency criteria evolve, the costs of doing so – in terms of development impact – are rising. The World Bank has commissioned an external review of capital adequacy, which is a tentative step in the right direction. But by using a private consulting firm and not joining forces with other MDBs, the review’s findings are unlikely to be perceived as authoritative and will have little broader impact.

1. \$658 billion in loans between 1944 and 2016, plus another \$23 billion in grants and transfers to the poorest countries.

2. Capital adequacy has not been an issue for concessional windows for the poorest countries, since they are not banks, although recent reforms at the World Bank’s International Development Association mean this could soon change.

3. This relates to MDBs lending mainly to the public sector. MDBs focusing on the private sector, such as the World Bank’s International Finance Corporation and the European Bank for Reconstruction and Development, do not benefit from preferred creditor status and have highly diversified portfolios compared to public sector-focused MDBs.

4. S&P briefing note (2016) ‘How Much Can Multilateral Lending Institutions Up the Ante?’ April 12.

This has all left shareholders at a loss to decide whether ratings agencies are credible or how to determine if MDBs need more capital or not.

Making the most of MDB shareholder capital

Five reform options can help maximise the MDB financial model such that these institutions can play their role in achieving the SDGs.⁵ None of these options require a capital increase. This is not to say that no further capital is needed to reach the SDGs – rather that MDBs should ensure that existing and potential future capital is most efficiently leveraged to meet shareholder goals.

External review of MDB capital adequacy

MDB shareholders should commission a credible external agency, such as the Bank for International Settlements (BIS) or the Basel Committee on Banking Supervision, to evaluate the best way to define MDB capital adequacy in conceptual terms. An external evaluation would provide a benchmark that would encourage convergence in how to assess MDB financial strength. A review could establish a minimum set of principles that would serve as a common reference point for ratings agencies, MDB shareholders and bond investors. Without this, the current uncertainty will continue, fuelling disagreements on MDB capital needs and undermining their ability to support the SDG agenda. Shareholders in combination with the G20 should insist on such a review, to overcome the resistance of MDB treasury staff (especially at the World Bank) to address the issue systemically for MDBs generally, rather than the current ad hoc, individual approach.

Evaluate the costs and benefits of going sub-AAA

MDB management and shareholders should set aside their categorical refusal to consider going sub-AAA. If holding on to a AAA rating undermines an MDB's ability to serve its developmental purpose, the rating goal should be reconsidered. A lower bond rating means potentially higher MDB funding costs (and hence higher loan rates to MDB borrowers) and has implications for liquidity management. On the other hand, a lower target bond rating can allow the balance sheet to grow substantially based on the same shareholder capital. MDBs should dispassionately analyse these trade-offs. If an MDB can achieve more with a AA+ or AA rating, this should be explored. The fact that an MDB like the Development Bank of Latin America (CAF) is able to operate very successfully in a middle-income region like Latin America with a AA- bond rating suggests that the fixation with AAA may be more an issue of prestige as opposed to pragmatism.

Issue subordinated debt or create new shareholding classes

An option to build equity without a capital increase could be to issue subordinated debt to institutional investors seeking low-yield, low-risk, long-term assets, potentially linked to MDB infrastructure projects. MDB management must first ascertain whether and how much benefit rating agencies would give such an instrument in their capital adequacy evaluations. A second possibility would be to create a separate, subordinated share class within MDB ownership structure for institutional investors such as pension or insurance funds. This model is currently employed successfully by a sub-regional MDB in Africa, the Trade and Development Bank (TDB). The main trade-off is that these new shareholders would require a steady return on their equity, which could conflict with an MDB's non-profit development aims.

Eliminate net income transfers for shareholder causes

One way to strengthen MDB finances is to allocate annual net income to reserves, which function like capital. However, non-borrowing shareholders have become accustomed to using net income to fund various causes, rather than paying for those causes out of their own budgets. World Bank shareholders have transferred a total of \$23.7 billion⁶ in International Bank for Reconstruction and Development (IBRD) net income from the 1960s through FY2016. Had this been allocated to reserves, the IBRD would have no need for a capital increase. If shareholders return just the portion of net income already transferred to the World Bank's International Development Association (IDA) and the AfDB's African Development Fund (ADF) concessional windows, this would boost the equity of the IBRD and AfDB by nearly \$15 billion and \$3 billion, respectively – about the same as AfDB's 2010 general capital increase, and three times the size of IBRD's. The foregone IDA/ADF reflows could be made up for by expanding the recently-approved bond issuing capacity of IDA and instituting bond issuing for ADF—a solution requiring no additional cost to taxpayers and no loss of concessional resources. The ongoing annual allocation of net income should cease or at least be scaled back, and these resources should instead be directed to reserves. Shareholders should use internally generated resources to strengthen their own cooperative, as MDBs were designed, and not siphon them off for causes benefiting only a sub-set of member countries.

Strengthen or repurpose callable capital

Callable capital totals more than \$650 billion for the World Bank and four major regional MDBs, but the vast majority is from countries below a AAA rating and of little

5. Several other options are being considered or are under implementation, including leveraging the 'hidden equity' in concessional lending windows and various balance sheet optimisation measures, are discussed in ODI Working Paper 509, April 2017 as well as in the companion paper in this series by A. Rogerson.

6. Current US dollars. \$14.8 billion was transferred to IDA and the remaining \$8.9 billion to various special programmes.

use to MDBs, according to rating agency methodologies. Three options could make better use of this resource, which is already committed by shareholders under international treaty obligations. These options would not increase the likelihood of callable capital actually being called, which has never happened at any MDB and is extremely unlikely ever to occur, due to the MDB business model and stellar repayment record.

First, MDB shareholders and their legislatures should more clearly define the circumstances and process by which callable capital can be called, which might convince rating agencies to give it more credit in their capital adequacy calculations. Second, shareholders supplying lower-rated

callable capital could enhance their capital quality with highly rated collateral like AAA-rated securities held by a central bank or BIS, or MDB management could purchase private insurance on a portion of callable capital (as TDB recently did). Third, the portion of callable capital below AAA but still investment grade is currently of no real use to MDBs, due to rating agency methodology. It could be put to a different use, for example serving as an MDB portfolio guarantee and thus providing capital relief, as recently demonstrated by Sweden (with the Asian Development Bank) and the UK and Canada (with the World Bank). To minimise the likelihood of being called, such a guarantee could cover only very low-risk portions of an MDB's portfolio.

Multilateral development bank support to country-led transitions from fragility and conflict to resilience

Alastair McKechnie

Fragility, conflict and violence (FCV) imperils the global imperative to eliminate extreme poverty and also lies at the heart of problems such as mass migration, trafficking in people and drugs, organised crime and terrorism. The locus of global poverty will overwhelmingly be in fragile, mainly low-income and African states by 2025 (Kharas and Rogerson, 2012). Fragility and conflict are negative regional or global public goods with consequences that spread across borders and which can affect almost everyone (McKechnie, 2016). Fragility is inherently a problem of ineffective institutions that lack legitimacy, capacity and the ability to respond to shocks.¹ FCV is no longer confined to low-income countries but affects middle-income countries and areas within otherwise well-performing countries. The New Deal for engagement in countries affected by fragility signed in 2011 and the World Development Report on Conflict, Security and Development (World Bank, 2011) reflect a broadening of support for fragile situations from traditional aid efforts that finance social services and infrastructure, towards a renewed focus on the political settlement, country-led institutional development, security, justice and jobs. Such a shift is reflected in the emphasis on fragile, conflict and violence-affected situations in both the latest International Development Association (IDA18) replenishment and the priority given to conflict prevention by the recently appointed UN Secretary-General.²

MDBs' comparative advantages in assisting FCV-affected countries

The multilateral development bank (MDB) model – combining large-scale finance, knowledge and expertise towards long-term objectives, and pooling resources and risk – is well suited to support the needs of countries affected by fragility:

- *First, MDBs have the finance, depth of expertise and scope that can support full-scale comprehensive approaches.* MDBs can achieve economies of scale in financing and knowledge intermediation that bilateral or smaller agencies cannot.
- *Second, by pooling funds, MDBs can avoid providing the fragmented assistance that overloads countries with weak institutions* and which can be ineffective in meeting peace-building and development goals. Multilateral aid channels are less fragmented than bilateral channels (Gulrajani, 2016: 14).
- *Third, MDBs can pool and manage risks.* FCV countries are some of the riskiest places to do business. In such countries, development support requires interaction with

governments that typically lack administrative capacity, are developing fiduciary controls and which are based on fragile political settlements that require distribution of economic rents to maintain stability and avert chaos. MDBs enable donors to pool risk and to transfer them to organisations that have developed the expertise to manage them.

- *Fourth, MDBs may smooth aid volatility in countries affected by fragility.* Stop-go aid has been the norm in fragile contexts (OECD, 2010a). It is often in response to political and security setbacks, or because bilateral aid is easy to mobilise in response to a crisis, compared with the long slog of institution-building and development.
- *Finally, MDBs can take the long-term perspective* that is necessary to build effective institutions, which can take 20 to 40 years (World Bank, 2011). Such an operational perspective is difficult for bilateral aid or most UN programmes. MDBs have an institutional legacy in financing infrastructure, where projects can take more than five years to yield results, and as multi-country cooperatives, have governance arrangements that insulate their management from short-term political pressures that lack a broad international consensus.

Legal rules and operational practices inhibit MDBs' full potential in FCV contexts

- *MDBs are challenged to operate in political space.* MDBs have articles in their charters that prevent them from interfering in the political affairs of a member country, and that require decisions to be impartial and based only on economic or social development considerations. In addition, MDB charters contain clauses precluding activities to which the member countries object (i.e. a government represented by its finance or planning ministry). In reality, any development intervention has a potential political impact since it can empower or disempower the incumbent political authority or its challengers (Yanguas, 2017). MDB shareholders and lawyers have interpreted non-interference clauses to prohibit a number of activities that may be vital to enabling good governance and peace. An example is developing local policing where neither bilateral nor other multilateral engagement has been effective or capable of long-term support tailored to country conditions.
- *Limits of a country-based business model.* While the country-based lending model has worked well in providing development finance to central governments, it

1. See for example Acemoglu and Robinson (2012), OECD (2010), OECD (2011) and World Bank (2011).

2. The Secretary-General made conflict prevention and peace his first priority in his inauguration remarks to the General Assembly on 12 December 2016 <https://www.un.org/sg/en/content/sg/speeches/2016-12-12/secretary-general-designate-ant%C3%B3nio-guterres-oath-office-speech>. These priorities are reflected in the proposed restructuring of the UN peace and security pillar (UN, 2017).

has been cumbersome in providing finance to sub-national governments, activities that span two or more countries and in engaging in countries where government may lack legitimacy. Sub-national fragility can exist in otherwise well-developing countries but may not be recognised by the national government (perhaps because the region might be populated by a minority without much political voice). If neglected, this could create a national problem that turns into a regional or global one. MDBs can lend to sub-national governments or other public or private organisations in the country, but require a sovereign counter-guarantee. Despite additional allocations for regional projects in concessional windows, regional FCV projects are more likely to be implemented as coordinated national projects, which is cumbersome in practice.

- *Blurring of development and humanitarian assistance.* When faced with governments with policies that retard development and nourish fragility and which have lost domestic and international legitimacy, the approach of MDBs has been to withdraw and let humanitarian organisations that bypass government take the lead. However, the humanitarian system is falling short in the eyes of the people it aims to help and is engaging in development activities such as long-term delivery of public services, e.g. health, education, water supply, while facing greater difficulty in mobilising finance (Bennett, 2016). Humanitarian action has contributed little to building institutions on which a resilient state can be founded although it has been possible to later incorporate NGO service providers into more permanent arrangements (Palmer, 2006). MDBs could engage more in the most fragile contexts where there is danger of conflict, even if it is not possible to work much with government, other than in a few islands of committed expertise. MDBs bring a longer-term approach that builds local institutions and can support transitions from temporary humanitarian instruments to more sustainable arrangements for delivery of public services.
- *Systemic underfunding of most FCV-affected countries.* Aid often goes disproportionately to richer countries, and little allowance is made for whether a country is suffering from a legacy of conflict or the regional or global consequences of new or renewed conflict. MDBs allocate most of their financial support to a country on the basis of Country Policy and Institutional Assessment (CPIA) indicators and indicators of the efficiency of project implementation. This basis for allocating aid has the disadvantage of being backward-looking, so it understates the potential for change in a country emerging from conflict or after a major change in government. Nor do these indicators give sufficient weight to preventing

FCV and the chaos that can destroy past development gains and cross borders. In addition, current aid allocation methodologies are based upon average income per capita, whereas an alternative based on the SDG goal of the number of people in *extreme* poverty could lead to more aid flowing to fragile situations, since extreme poverty tends to be more concentrated in these conditions (McKechnie and Manuel, 2015: 109–110). While some MDBs do provide additional allocations for countries affected by FCV, this is insufficient to offset the funding distortions created by other international partners that create ‘aid orphans’, or to compensate for the conflict years without MDB finance, or to prevent future conflict.

- *Slow, inflexible operational response.* The two MDBs most active in countries affected by fragility, the World Bank and AfDB, have been criticised for their cumbersome fiduciary systems (which can be alien to a borrowing country’s financial management, audit and procurement systems) and the lack of overall flexibility in their administrative procedures (AfDB, 2012: 39; MOPAN, 2010, 2012). This has been compounded by the reliance on externally recruited staff with limited knowledge of the banks’ processes in MDB offices in FCV-affected countries (which are unattractive to regular staff). In addition, a survey of World Bank staff found that most believed that the Bank’s procurement processes were not well adapted to FCV-affected countries (World Bank, 2013: 40–41). While both the AfDB and World Bank recently have adjusted their procurement regulations to allow greater flexibility, this may not lead to much change without improved staff incentives for risk-taking and management. Similarly, the trend towards results-based lending and greater use of country systems has bypassed fragile contexts, despite their benefits in spurring institutional development, a lack of which excludes the country under MDB rules. Kenny (2017) has gone so far as to propose a new approach to managing fiduciary risks based on financing observed results rather than finance-based evidence of expenditures.
- *Unsuitable instruments to support institutional development* – critical for the transition from fragility to resilience. Such support from MDBs is mainly through analytical work financed through their administrative budgets presented in reports, often to support lending, or through technical assistance loans subject to minimum size limits and normal lending criteria. These may be valuable in clarifying strategic choices or in financing computer systems needed for modern institutions (e.g. finance ministries) to function. However, along with policy-based lending these instruments may promote international ‘good’ practice that has little country ownership and fails to work in practice.³ These instruments are not well suited

3. Examples from the extensive literature on why best practice institutions fail to achieve their intended results include Pritchett et al. (2012), Moore et al. (2010) and Levy (2014).

to helping countries resolve collective action problems that constrain development (Booth, 2012), or to providing the ‘trusted advisers’ that can facilitate country-led solutions (Williamson, 2015).

Recommendations

MDBs and their shareholders are recommended to take these actions to strengthen effectiveness in fragile contexts in terms of both development and conflict prevention:

1. Review the interpretation of political non-interference mandates in the context of fragility where development and politics inevitably intersect. A narrower interpretation might return to the original intent of their mandates to tolerate variation in constitutional arrangements and economic policies and to not influence electoral processes. This could, for example, enable greater MDB engagement in strengthening accountable police and judiciary that respects human rights, disarmament of irregular forces, security sector reforms and enhancing oversight by legislatures. Reinterpreting mandates to allow more ‘political’ MDB activities might also require changes in MDB governance arrangements to ensure decisions have legitimacy and broad international support,⁴ e.g. a formal role for the UN or regional organisations in decisions to allocate resources, perhaps starting with trust funds that have a significant share in MDB financing to conflict-affected countries.⁵
2. Work around the limitations of the MDBs’ country-based operational model, particularly how to provide funding for activities that cut across national borders or to support organisations that are independent of weak government. One option is more creative use of MDBs’ grant instruments, where there is no repayment obligation or concerns about creditworthiness, to fund both national and regional projects that reduce FCV.
3. Contribute to a seamless engagement in fragile situations by development, humanitarian, peacekeeping and diplomatic policy communities through deepening the growing partnership with the UN and regional organisations, which have international legitimacy in areas beyond development, but which lack capacity, funding and influence with government. MDBs could fund humanitarian actors as part of a long-term plan that assures results and fiduciary accountability and jointly
4. Utilise MDBs’ finance and banking expertise to promote innovative and coordinated financing to tackle FCV. MDBs can use their grant, concessional and trust funds more creatively, particularly to address subnational fragility, cross-border problems and in providing basic services in countries with very weak governance that may temporarily bypass the state. Multi-donor trust funds (MDTFs) can also address many of the constraints faced by MDBs. MDTFs can allow a subset of MDB shareholders to accept higher risk in a country at risk of conflict, increase strategic coherence among partners, reduce aid fragmentation and lower transaction costs to the country. MDBs can fill the current gap in financial instruments that specifically address FCV in middle-income countries and to enable a shift to financing results, perhaps verified by third parties, rather than directly financing project expenditures.
5. Deepen support for institutional development in FCV-affected countries, rigorously evaluating pilot approaches and scaling up what works. Areas such as public administration reform, public utility management, and oversight of the security sector are ripe for new, innovative approaches by the MDBs and their partners. The PDIA, ‘Doing Developing Differently’ approach seems worth pursuing,⁶ but this entails a facilitation approach that requires seasoned staff with difficult to measure short-term results. A new capacity development instrument is needed that can apply modest amounts of flexible, long-term support through advisers capable of facilitating country-led change.
6. Shareholders need to strengthen their oversight of MDB operations in FCV-affected countries since MDB performance has varied across countries. This would involve greater attention to implementation, speed of results, and impact on peace and development, rather than loan approvals. They could also ensure that MDBs are fit for the challenge of fragility, especially through: adjusting their policies and procedures for greater agility in fragile contexts; decentralising highly qualified, empowered staff to country offices; using country systems wherever possible; and providing hands-on support to counterparts in low-capacity countries.

4. The package of economic reforms known as the ‘Washington Consensus’ is an example of an MDB programme, however well justified technically, which was promoted by a small group of MDB shareholders and which lacked political legitimacy in some countries forced by their circumstances to accept them.

5. The Somalia Development and Reconstruction Facility (SDRF) is an example of governance arrangements that include bilateral, multilateral, (including UN and regional organisations) and the national government in the management and accountability of subsidiary funds administered by the African Development Bank, UN and World Bank.

6. On Problem-Driven Iterative Adaptation (PDIA) see Andrews et al. (2012) and for a description of the Doing Development Differently movement see <http://doingdevelopmentdifferently.com/> and <https://www.odi.org/projects/2857-doing-development-differently>

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Gradation, not graduation: why and how multilateral development bank financing of middle-income countries needs an overhaul

Andrew Rogerson

Tensions regarding middle-income country aid allocations are not new, but are newly pertinent (Kharas and Rogerson, 2017). For example, in 2005, aid from all donors to upper middle-income countries (UMICs) was around 30% of official development assistance (ODA) net disbursements and it evidently seemed sensible to reduce this level. By 2015, UMICs accounted for just over 10% of ODA receipts (ibid.). This may have been a shift too far for aid providers moving to priorities other than poverty reduction and justifying aid also in terms of national interest, quintessentially for global and regional public challenges like climate change and migration.

The idea of a ‘graduation’ of developing countries from one set of assistance terms to another, as their incomes rise and their market access improves, is deeply embedded in official finance culture. It still frames a largely linear transition from the soft(er) to the hard(er) windows of some MDBs, the World Bank in particular. That in turn usually signals the start of phasing out ‘concessional’ support from other official providers.¹ It also eventually leads to the question of UMIC graduation altogether from borrowing on any terms from multilateral development banks (MDBs) (Prizzon et al., 2016).²

There are two problems with the graduation process from soft windows of concessional assistance. First, there is the risk of ‘herding’ or cliff-edge effects. Crossing this income threshold typically triggers a fuller graduation process within MDBs. Any income threshold taken in isolation makes little operational sense (Kharas et al., 2014).³ This process includes a formal assessment of creditworthiness, and in its wake provides time-bound transitional terms (e.g. the ‘IDA (International Development Association) blend’, meaning simultaneously reduced access to the soft window as well as progressive access to the hard one). The final ‘exit’ from all access to MDB concessional terms, particularly for large historic users like India (IDA17) and soon Vietnam (IDA18), involves further tailor-made transitional facilities, on increasingly harder terms. But such processes remain to some extent opaque (or are perceived as discretionary) and can be misinterpreted, particularly outside the institutions implementing them. There are therefore inherent risks of a ‘cliff-edge’, whereby overall external support is withdrawn too fast from recent graduates, whose own fiscal resources

are not yet growing fast enough to close the gap, so at the very least the process needs smoothing (ibid.). That requires more transparency and coordinated action among the MDBs and their larger shareholders who are also bilateral providers of concessional assistance.

Second, the majority of the world’s sovereign nations – middle-income countries (MICs) and especially UMICs – are no longer significant recipients, nor yet, with few exceptions, major providers of concessional assistance. So, most discussions around ‘aid’, or more generally concessional finance, fail to engage them directly. But they nonetheless still need access to appropriate public international funding. That is justified, as we see below, in particular to help them play their indispensable part in tackling regional and global challenges like climate change, infectious disease and unsustainable migration, with domestic repercussions but also major international spill-over benefits.⁴

Implications for the MDBs

MDBs’ inadequately catalytic role in MICs. MDBs are not playing a sufficiently catalytic role in MICs, particularly in infrastructure finance, despite their well-honed ‘from billions to trillions’ rhetoric. Overall MDB hard-window net lending in real terms has been flat or negative for decades, except for a sharp spike in response to the 2008/09 global crisis (Birdsall and Morris, 2016). In the first half of 2016, MDBs as a group supported only \$1.2 billion in infrastructure projects with private participation (Kharas and Rogerson, 2017)

The reasons for limited MDB engagement in MICs relate to both supply and demand. On the supply side, the largest MDBs, such as the International Bank for Reconstruction and Development (IBRD) and International Finance Corporation (IFC), are starting to feel the pinch of too little equity (ibid.). Their conservative shareholders are keeping them on a short leash, offering neither additional paid-in capital nor relaxing prudential lending standards or authorising other balance-sheet optimisation choices at full scale. The World Bank (IBRD), for example, is already sharply cutting back on its planned lending volumes, fearing that it might not be able to get a capital increase that would permit it to sustainably maintain or

1. This dualistic model applies in particular to the World Bank (and International Development Association (IDA)) and to the African Development Bank (and African Development Fund (ADF)); only to a lesser extent to the Asian Development Bank and Inter-American Development Bank (IADB) (which have both recently unified their windows); and is also not so relevant for the European Bank for Reconstruction and Development (EBRD), given its overwhelmingly middle-income membership.

2. Opposition by the US Government to the International Bank for Reconstruction and Development lending to China has focused renewed international attention at the time of the 2017 IMF–World Bank Annual Meetings.

3. Direct indicators of, for example, creditworthiness, fiscal capacity and fragility must be factored in, but these vary far more within the larger MIC spectrum than around the immediate LIC–MIC divide (\$1,005 in 2016 terms) (ibid.).

4. A case can be made that even emerging economies in the higher income echelons that have recently ceased to be eligible for MDB loans altogether, or in a handful of cases (e.g. Thailand on sovereign operations, Malaysia) have chosen unilaterally to stop borrowing, should be encouraged to remain engaged in the GPG area, through appropriate burden-sharing terms and reduced transaction costs and hassle factors (see Birdsall and Morris, 2016).

grow above 2016 lending volumes. The same constraint is present to varying degrees in other ‘traditional’ MDBs.⁵

On the demand side, many developing countries are cutting back on public investments in the wake of tightening credit conditions, including via regulatory disincentives (e.g. Basel III risk-weighted capital adequacy requirements) to emerging market exposure by commercial banks. MDBs are indirectly affected by this restraint, especially when they aim for high co-financing with private lenders. A different set of demand-side constraints relate to the allegedly very high non-financial costs, including political costs and risks, of accessing the MDBs. We do not develop this topic further here.

Funding global public goods. A more specific problem within this overall lack of dynamism in the MDBs’ offer to MICs is the urgent need to support MICs to help tackle global and regional challenges, particularly climate change mitigation, control of communicable diseases, protection of global financial stability and management of unsustainable migrant pressures, for which their role is essential. In the latter case, for example, the UMICs around Syria bear a disproportionate share of the burden of resettlement for displaced persons (Kharas and Rogerson, 2017). Creative solutions have been found on an ad hoc basis to provide Lebanon and Jordan, in particular, with new concessional finance in exchange for labour market reforms leading to sustainable migrant integration (ibid.). Such approaches should and could become more systematic, but that presupposes a reappraisal of the relative priority of routing partly concessional international public finance via MICs.

Implementing such changes and the implications for MDB funding and governance

A ‘gradation’ approach towards MIC access to partly concessional terms. Given the uncertainty in global conditions, it does not make sense to codify any given percentage of aid (access to concessional finance) to be reserved for non-IDA MICs and in particular, UMICs. A softer approach, which could be termed ‘gradation’,⁶ accepts the desirability of a decline in (grant-equivalent) aid as recipient countries become wealthier, but also permits different aid allocations as conditions and motivations change, especially where there is a strong global public good (GPG) dimension.

There would need to be sufficient ‘guard rails’ to ensure that programmes supported under this rubric actually delivered substantial international spill-over benefits, and also a fair scale of partly-concessional terms which reflects

the expected balance of national and international returns. These are likely to differ between thematic areas (see Birdsall and Morris, 2016 on differential pricing).

One institutional option to implement this approach would be to allow extended eligibility for use of concessional windows, earmarked for a specific set of GPG-related purposes, to countries like India that would otherwise have become ineligible for concessional terms. Ideally, to avoid the appearance of making multiple case-by-case exceptions, creating a more systematic GPG ‘facility’ for all or most MICs, with different tiers of subsidy if necessary, might be a better strategy.

Using part of the IDA’s borrowing capacity for graduated MICs. For the World Bank, with its inverted-pyramid structure of a fast-expanding soft window (IDA) and a stagnant hard one (IBRD), and huge, largely untapped quasi-capital represented by the IDA receivables book, there is a choice to be made to design a path towards an eventual merger of the windows.

For the next few years, IDA (IDA18, running from July 2017 to June 2020) will be borrowing cautiously in its own name against this collateral, as part of the overall so-called replenishment envelope. These borrowing proceeds (approximately \$25 billion, or one-third of overall IDA18 funding) will go into the IDA resource pool and be allocated under the same rules as the rest of the resources mobilised. They will be exclusive to IDA recipients, so they will not be directly usable by MICs who no longer have IDA access.

Where there is a strong ‘externality’ rationale for the latter countries to obtain concessional terms, as in the Syrian refugee case, such support currently has to be funded by additional external grant streams (donor trust funds, like the Concessional Financing Facility). These coincidentally come from very similar sources to IDA’s. However, donor contributions to ‘replenishment’ actually fell in IDA18 relative to the previous three-year arrangement, so the entire increase in headline IDA resources (and more) was funded by these new market borrowings as well as by internal transfers. So, traditional donors are already indirectly switching their concessional finance focus towards GPGs and MICs, albeit not transparently or systematically.

Expanding eligibility for use of the proceeds of IDA market borrowings to support MICs for global and regional public goods, which benefit IDA countries indirectly, would open a path towards eventually merging the two funding windows, with larger implications for their combined ownership.

5. Chris Humphrey cites analysis done in the G20 working group in late 2016 that finds that the five major Western multilateral agencies have around half a trillion dollars in unused financial capacity (‘headroom’) because of conservative financial practices reflecting major shareholders’ cautious approach to risk (Humphrey, 2017).

6. Kharas and Rogerson, op.cit., after Sagasti, 2013, but with specific reference to GPG-related operations.

Offering MICs a greater formal or de facto governance stake in a more integrated MDB system. This immediately prompts the overarching question of the representative ownership of, and relative use of and confidence in, the MDBs as a whole. A purely mechanical merger of IDA and IBRD, for example, blending the unchanged ownership patterns of each, would simply dilute the combined share of emerging and middle-income countries compared to OECD ones. This flies in the face of the generally agreed MDB governance principle that voting rights should become increasingly representative of new global economic realities, and is therefore something of a ‘poison pill’.

The situation arises because these rights are currently distributed asymmetrically between the two windows, with a relatively greater representation by MIC borrowers in the hard window, and of historical ‘donor’ countries in the soft one.

Conversely, the future financial sustainability of the soft windows now increasingly depends on transfers of

net income derived from the hard windows (and IFC), and from repayments. These are generated largely by operations involving MICs, which are now straining at their financial limits.

Which broad shareholder group actually ‘owns’ these flows, be it the original equity providers or current MIC borrowers, is debatable. Moreover, IDA market borrowings are indirectly underpinned by IBRD’s market reputation and flawless debt servicing record, ultimately dependent on MIC repayment discipline. Also, as these IDA borrowings are now effectively priced by markets as if they were IBRD ones, they require much more subsidy to convert into standard IDA terms than into terms closer to IBRD, and still plausibly attractive to MICs. Finally, IDA subsidy needs will balloon if, or when, market rates harden considerably, as standard IDA terms are pegged at 0.75% (in a currency basket) while IBRD terms float with market reference rates.

For all these reasons a joint, integrated approach to ownership of both sets of windows is imperative.

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Why do countries want multilateral development bank assistance? Views from recipient countries

Annalisa Prizzon

Over the past decade, economic growth in several developing country economies has outpaced previous records in modern history. Such macroeconomic performance has meant a larger tax base, more developed financial markets and increased confidence in international capital markets. At the same time, financiers have proliferated: sovereign donors have increasingly shifted from technical to financial assistance and philanthropic organisations have taken up more prominent roles in international grant-making. Recipient country governments now have at their disposal a larger set of financing options to implement their national development priorities – what Prizzon et al. (2016) labelled an ‘Age of Choice for development finance’.

More financing options have also meant that several recipient country governments have become more assertive in negotiating and managing different providers and sources of finance. Borrowing countries have improved their ability to articulate, and follow through on key priorities for development finance. Main priorities have included securing greater financing volumes, especially for infrastructure, ownership of development programmes, alignment to national priorities, speed of delivery and diversification of financing portfolios.

Earlier attempts to reform the global financial architecture were deeply rooted in the perspective of international financial institutions (IFIs), primarily supply-driven. Any credible reform of IFIs cannot overlook the current and future characteristics, demands and preferences of the countries that these institutions are meant to serve and support. Country ownership of development programmes entails prioritising the needs of the beneficiary country above those of the financiers. Such an approach means the borrowing country takes greater responsibility, with projects more likely to be sustained in the future and better grounded in the country context, thereby strengthening institutions and processes.

Recipients prefer MDBs but their advantage is now challenged

Multilateral development banks (MDBs) are in general highly valued by recipient countries and they are more effective and efficient than traditional bilateral donors. MDBs offer and deliver large-scale finance, longer-term projects, greater depth and breadth of technical assistance/expertise, more useful advice, and more incisive influence over development than bilateral donors (Davies and Pickering, 2015; Custer et al., 2015). Most multilateral organisations are more aligned to country priorities, have less conditionality, demonstrate greater predictability of programmes, have a clear strategic focus with a stronger

commitment to the use of country systems than bilateral donors (Davies and Pickering, 2015). MDBs’ soft windows are also among the top performers in terms of maximising efficiency,¹ transparency and learning, and reducing the burden on recipient countries (Birdsall and Kharas, 2014). They have a clear ‘performance edge’ compared to Development Assistance Committee (DAC) and non-DAC bilateral donors (Custer et al., 2015).

However, the MDB model combining large-scale finance, at interest rates lower than countries could borrow from capital markets, policy advice and knowledge, is under threat. The number of financiers catering to developing country governments and private sectors and the volume of transactions they complete have expanded over the past decade, often entering the space mostly occupied by MDBs. This change has three dimensions to it.

First, over the past five years several sub-Saharan African (SSA) countries have been issuing sovereign bonds in international financial markets, including those that benefited from multilateral debt relief initiatives in the 1990s and 2000s. International sovereign bonds do not come with policy conditionality and funds are available immediately at amounts that other lenders, especially MDBs and bilateral DAC donors, might not be able to mobilise (Prizzon et al., 2016). Borrowing from international financial markets can signal either that non-financial terms and conditions of MDB assistance are less attractive and/or financing needs are far greater than MDB lending can address. These financing options are far more expensive than MDB lending, even from the hard windows, because of their short maturity and often high annual interest rate, close to two-digit figures for some countries. This potentially raises concerns about future debt sustainability and debt management, with debt service already becoming more expensive in several SSA countries. Developing countries are also creating their own purpose-built bilateral, regional and multilateral institutions to provide market-based public lending.

Second, MDBs are no longer the only organisations offering policy advice (even though it is usually part of the overall programme/projects), with large international consulting firms now well established in this area too. Knowledge and technical assistance are core activities of MDBs but, for example, more than 50% of respondents in the Davies and Pickering (2015) survey felt that multilateral institutions could do more to ensure their country offices supported development of local capacity.

Third, MDBs will find meeting recipient country priorities harder when it comes to speed of delivery, investment in priority sectors, assessment of demand for assistance and coordination with other MDBs and donors to reduce transaction costs.

1. The higher the share of aid channelled to poor, well-governed countries to support global public goods, and to untied aid as well as to areas of comparative advantage with lower administrative costs, the higher the score.

- In Ethiopia and Kenya, the governments have expressed high demand for MDB financing, especially at concessional terms, but MDBs are supply-constrained due to limits to their concessional resources, or country exposure risks (Jalles d'Orey and Prizzon, 2017). Some government interviewees mentioned that they would be willing to borrow more from the MDBs, given their favourable terms and conditions on interest rates, maturity and grace periods in comparison with other more expensive options, such as international sovereign bonds. However, we have little evidence about recipient country governments' level of demand for concessional and non-concessional finance. Despite some analysis of recipient country perceptions of MDB performance (Davies and Pickering, 2015; Custer et al., 2015; Birdsall and Kharas, 2014) and a client feedback survey by the Inter-American Development Bank in its member countries in 2015, we have very little information on the volumes of demand for assistance and the perceived comparative advantage and preference for each MDB.
- Sectors that are a high priority for some recipient country governments may not be seen as viable for investment by MDBs. For example, in Ethiopia traditional donors – especially MDBs – are not involved in the railway sector because project costs are high, risks are high and rates of return are low.
- Certain recipient country governments seem to place high value on speed of contract negotiations and project negotiations (Prizzon et al., 2016). Delays push up the administrative and opportunity costs of projects that are not yet in place or fully operational. For example, in Ethiopia, speed is considered such a high priority that there are cases of concessional loans being rejected in favour of less concessional financing from China because the negotiation and procurement processes were taking too long, safeguards were too burdensome and there were differences between local laws and MDB policies. In the Davies and Pickering (2015) survey, government respondents described the MDB policy and procedural rigidities as irritants. Together with alternative financing options, evidence suggests that MDB policy conditionality – as well as conditionality imposed by other donors – might become less effective.
- Formal coordination at the country level is often very limited, especially in infrastructure development, usually the core area of MDB intervention. For example, the division of labour in the road sector is often based on splitting one main project into a number of smaller ones, with the government allocating a specific section of the road to each donor through parallel arrangements. Not surprisingly, the use of more than one donor procurement and reporting system represents a key challenge for governments (Jalles d'Orey and Prizzon, 2017). However,

MDBs can bring considerable convening power and assist governments in coordinating at project, sector and national levels. By pooling the funding of bilateral donors and through co-financing arrangements, MDBs can reduce the fragmentation of external financing, the proliferation of small projects and the high transaction costs to government of coordinating fragmented assistance.

Recommendations: MDBs should pay more attention to recipients' perspectives

MDBs, individually and as a system, should strive more to factor in the perspectives of their client base and of the constituencies they support to help these countries achieve their development goals and follow through on their strategies. This is far from an easy objective to achieve given the pressure on multilateral institutions to deliver results, increase efficiency and value for money. However, if MDBs are to be effective in achieving their own mandates and in helping to progress the development agenda globally and locally, then recipient country perspectives and preferences cannot be overlooked. MDBs should leverage their unique contribution of knowledge, capacity-building and convening power. In particular, MDBs should consider the following actions.

1. Individually and as a group, MDBs should better define the future demand for their assistance in relation to their competitors, and in relation to preferred terms and conditions, and perceived comparative advantage. Such an analysis will inform the trajectory that MDBs should take in terms of financial and operational scale.
2. Diversify financing instruments with differentiated financing terms (interest rates, fees, maturities, grace periods), based on an objective, granular assessment of the country context rather than a broad lending category only. Favourable financial terms and conditions for both concessional and non-concessional assistance are no longer sufficient to generate demand for MDB assistance but they remain a key advantage that the more traditional MDBs should strive to maintain. Furthermore, building upon their common interests, they should invest more in knowledge and policy advice across MDBs, deepening their capacity to respond to country context, needs and demand.
3. Further improve speed of delivery. Most MDBs have reviewed their procurement and safeguard policies but there is scope for accelerating incremental progress towards wider use of country systems. This would include environmental, social and human rights safeguards, delegate more decision-making authority to the country level and streamline internal process reviews, focusing on those that are key to ensure project quality and development impact.

4. Use MDBs' comparative advantage and convening power for more effective coordination of foreign assistance at the country/project level by strengthening the coordination capacity and authority of governments to reduce transaction costs for recipient countries. Such coordination requires working closely with governments

to engage all multilateral and bilateral actors providing assistance to the country. Shareholders should incentivise the use of such platforms at the country level to benefit from economies of scale, also well beyond current initiatives of coordination among MDBs in the infrastructure sector.

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