CHAPTER 1 DEVELOPMENT FINANCE AND THE ORIGINS OF DEVELOPMENT FINANCE INSTITUTIONS (DFIs)

Introduction: Definition of Development Finance for the DFIs

1.01 As generally used, the term *development finance* is synonymous with 'foreign aid' or 'finance for development'. In the financial world, it has a connotation different to these other semantically proximate but conceptually distinct notions. At the risk of over-simplifying, *foreign aid* embraces a wider set of financial flows between the developed and developing worlds than those concerning 'development finance' *per se*. Typically, foreign aid includes *emergency relief* in the case of wars or natural disasters (e.g. droughts, famines, earthquakes); *humanitarian assistance*; *food aid*; *technical assistance*; *military aid*, and *programme aid* (for financing imports or budget deficits or, more often, for both). Such aid may be unconditional or conditional (e.g. in supporting structural or sectoral adjustment). In fact, the *development finance component* of foreign aid (broadly interpreted as *project aid*) to Africa has been shrinking since 1980 given the demands that the continent has made on diminishing donor budgets for other types of aid.

1.02 Any connection between ***foreign aid*** and development finance in the context of this Study is therefore limited to those instances in which external assistance is provided for:

- ***project-aid***: i.e. delivered directly by donors or through specialised domestic intermediaries (DFIs) or other specialised credit institutions (e.g. for agriculture or small and medium enterprises -SMEs) which provide long-term credit involving some form of implicit or explicit subsidy; and

- ***investment in the non-social sectors***: i.e. investments in agriculture, agro-industry mining, manufacturing, commercial services (e.g. tourism, construction and financial services) and infrastructure (e.g. electric power, oil and gas production and pipelines, water supply and sewerage, solid waste disposal, telecommunications, and all modes of transport for people and goods); as well as small and medium enterprises (SME) and micro-enterprises; but *excluding* projects in education, health, nutrition, population, and the environment. These social sectors are usually financed through budget and import support, or through special sector programmes, but not usually through development finance.

1.03 Similarly, a semantic distinction is made in this Study between the terms development finance and ***finance for development***. The former has a specific meaning (explained below) while the latter, very broadly, implies *all* forms of finance applied to attaining the objectives of development. Thus 'finance for development' would generally include: foreign aid, public finance, commercial finance (whether supplied by private or publicly-owned institutions and domestic/foreign capital markets) and development finance.

1.04 That disquisition may also seem too obvious to require articulation. But, discussions on development finance suggest that confusion between these terms arises with sufficient frequency to justify highlighting and dispensing with it at the outset.

Development Finance and the Origins of DFIs

1.05 Having dwelt on what it is *not* it might be appropriate to define what ***development finance*** is. The notion of development finance (provided through a development finance institution) is essentially a post-1944, Bretton-Woods notion. It involves some combination of any or all of the following six elements:

With regard to financing ***of*** *development finance institutions*

- Sureties provided by a limited amount of credible *public* (i.e. sovereign) *cash equity* capital - sometimes augmented by capital from Multilateral Development Banks (MDBs) or private sources as well - and, more importantly, by credible *public guarantees* by way of: (i) callable capital provisions which leverage the cash capital paid-in or (ii) specific guarantees provided for borrowings on international or domestic markets (for a more detailed elaboration please see World Bank: 1976, and Mistry:1995).

- Resources borrowed from private domestic and/or international capital markets, and/or from MDBs and bilateral lenders, at prevailing market rates usually through public or privately placed bond issues and/or syndicated bank loans. Such resources are sometimes augmented by loan funds provided by domestic governments on a longer term at a sub-market or minimal cost.

- Some form of implicit or explicit subsidy to the DFI on the resources lent or invested by providing: its equity resources on a dividend-free basis; a subsidy on the cost of funds from lenders; reduced or zero fees for government guarantees; full or partial coverage of exchange risk on foreign borrowings; or preferential domestic tax treatment.

With regard to funding ***by*** *development finance institutions*

- A partial transfer of the *subsidy* (indirectly or directly) to the ultimate borrower either by way of *below-market cost* of funds (a practice discontinued quite quickly in the developing world other than Africa) or in the *tenor* (i.e. maturity and grace periods) of funds which the borrower would not have been able to obtain from any commercial source.

- Less onerous requirements for *collateral* from borrowers than are normally required by commercial lenders; often the collateral of the assets being financed are sufficient for a DFI.

- *Monitoring and supervision* by the lender over the use by the ultimate borrower of development finance funds provided.

1.06 ***Development finance*** is usually applied to investments in revenue-generating enterprises and projects or ventures whether public or private. The projects financed may be: (i) commercially profitable; or involve (ii) full-cost recovery autonomous to the enterprise; or (iii) partial cost recovery, with an explicit subsidy provided by the fiscus at whatever level of government to cover the balance. Development finance usually distinguishes between capital and recurrent expenditure. Its application is generally confined to the initial capital outlay (and the first cycle of working capital requirements) with future recurrent costs being covered through internal cash generation from the project or through normal commercial working capital arrangements.

1.07 Thus there is a clear contrast between development finance and ***public finance*** that is:

- mobilised from tax and other revenues derived by all levels of government, given their respective revenue powers;

- focused on investment or expenditure covering (fully or partially) the provision of public goods, social goods and essential community services, that are provided as free or mostly free goods, i.e. non-revenue generating goods and services;
- subject to government accounting rules, which make no distinction between capital and recurrent costs; and
- expensed annually.

Emergence of a Tiered Structure of DFIs - from Global to National to Regional

1.08 The combination of elements that make up *development finance* was forged when the International Bank for Reconstruction & Development (IBRD - more commonly known as the ***World Bank***) was established. Modern development finance thus came into being at the *global* level. The IBRD started on-lending through *national* finance companies in 1949 beginning with the Netherlands and Finland. With the formation of its private sector affiliate - the International Finance Corporation (IFC) - in the mid-1950s, that practice spread to almost every developing country. It resulted in the creation of new, special-purpose, development finance institutions (DFIs) designed to fill gaps in the term-lending capabilities of local banks in environments with undeveloped capital markets. In the mid-1960s the World Bank shifted the locus of this activity from IFC to itself. The Bank and IFC often acted jointly to establish national DFIs. The IFC invested in part of their initial equity capital while the IBRD provided long-term loans. The World Bank thus acted as a wholesaler of development funds that were retailed through national DFIs.

1.09 Between 1955-90 five major ***Regional Development Banks*** (RDBs) emerged at a mezzanine level between the global and national DFIs. These RDBs were established successively for Latin America and the Caribbean (IADB - *Inter American Development Bank*), then Africa (AfDB - *African Development Bank*), followed by *Asia* (AsDB - *Asian Development Bank*), the Islamic world (IDB - *Islamic Development Bank*); and most recently for Eastern and Central Europe (EBRD - *European Bank for Reconstruction & Development*). At present, a new *Middle East Development Bank* (MEDB) is being contemplated involving the participation of OECD countries and Israel with its Arab and Palestinian neighbours in the shareholding structure.

1.10 The *European Investment Bank* (EIB) is frequently classified as one of the RDBs. But, even though it is now larger than the World Bank in terms of assets, it is of a different genre. EIB is essentially a sub-regional bank focusing primarily on investments involving internal transfers of structural funds within the European Union. Unlike the RDBs it was not set up *mainly* to intermediate funds between developed and developing countries, although it was set up to finance investments in Europe's poorer 'regions', even within its richer countries. However, the EIB does transfer resources between developed and developing countries to a limited extent. It acts as a conduit for concessional (EDF) and non-concessional EU lending to the African, Caribbean and Pacific (ACP) countries that are signatories of the Lomè Convention and to other developing countries with which the EU has associate relationships. As more Central and Eastern European countries join the European Union, the nature of the EIB's role will expand and change as an intermediator of resource flows between the richer (Northern an Western) and poorer (Eastern and Southern) parts of the European continent.

1.11 The RDBs, patterned on the same lines as the World Bank, were created not because the development finance needs of their respective regions could not be met by that institution. They appeared because the political economy of relationships between the developed and developing countries in each region resulted in demands for different, more user-friendly shareholding structures, along with a wider range of development financing services than the WB provided at the time. Political pressures for establishing the RDBs became compelling because regional rather than global shareholding structures *appeared* to allow borrowing member countries to have greater influence over policy-making and decision-making control in 'their' regional institutions than they ever could in a global DFI dominated by developed countries.

1.12 That perception has, however, proven to be illusory. It has become clear (especially in the aftermath of the debt crisis of the 1980s) that *creditor countries* providing usable (i.e. convertible currency) resources, and especially soft-window funds, to the RDBs retain more power and influence in policy and decision-making rather than *borrowers*. This issue was tested, and resolved decisively in favour of creditor-shareholders (including *non-regionals*), when the capital and soft-window resource replenishments of the IADB and the AfDB (Mistry: 1995) were last negotiated in the mid- and late 1990s.

1.13 Despite that uncomfortable reality, it can be argued that regional shareholding structures do provide borrowing members with more bargaining power and room for manoeuvre than they have in global institutions such as the WB and International Monetary Fund (IMF). The IMF, of course, was never intended to be a DFI. In the aftermath of the debt crisis, and with no role left to play in managing trade and exchange regimes in the developed world (for which it was created), it has become principally a balance-of-payments financier to developing countries, by default than design. In that sense it has become a larger financier of development than it has ever intended to be.

1.14 A panoply of global and regional *multilateral development banks* (MDBs) has now emerged in the international financial system. They were originally created to fill genuine gaps in the capabilities of capital markets to meet the financing needs of developing countries. But their existence and growth in the 1990s appears to be more supply rather than demand driven. It is questionable whether this array of MDBs - along with similar, smaller, multilateral off-shoots such as the OPEC Fund, various Arab multilateral banks and funds, and the International Fund for Agricultural Development (IFAD) - continues to add any real value to developing countries as the beginning of the new millennium.

1.15 It is not indisputably clear that the MDBs - individually or collectively - are enhancing, at the margin, incremental funding prospects for developing countries. Nor do they appear to be catalysing or triggering the kind of product/service innovations, which are needed through competition in their own community (Mistry:1995). They are certainly not doing so at a pace commensurate with the activities of private financial institutions in developed or emerging markets. After having had a significant positive impact on the developing world between 1955-85, a number of unanswered questions are now surfacing about whether MDBs (especially their quasi-commercial hard-windows) - remain relevant in a changed operating and globalised financial environment.

1.16 The benefits derived by developing countries as a whole by way of resource transfers or development multipliers from MDB operations are insignificant compared to the substantial administrative costs involved in running these large bureaucratic institutions. Yet, it has to be remembered that private capital flows to developing countries, while having increased exponentially in the 1990s, remain concentrated in fewer than 20 countries. These absorbed 95% of such flows. The MDBs therefore remain important providers of development finance in *gross terms* (and especially of concessional soft-finance) to the majority of low-income developing countries; even as their significance to countries with access to global capital markets wanes.

1.17 Despite awkward doubts about their continued value and utility, there can be no question that the MDBs have established both credibility and reputation in international capital markets.

That enables them to leverage their hard-window resources collectively to levels well in excess of the demands that their creditworthy clients are making on them at the present time. For a moment, the Asian financial crisis of 1997-98 seemed to belie that notion. It bestowed on MDBs a new lease of life for crisis management. But the Asian crisis (as well as the Mexican crisis which occurred before it in 1994-95) showed that the expectation of multilateral bank (and IMF) intervention in financial crisis management might actually be a cause of moral hazard rather than a remedy for it.

1.18 Absent the Asian financial crisis, the potential aggregate financial intermediation capacity of the present array of global and regional MDBs would have remained under-utilised. But, after the immediate panic of 1997-98 subsided, the Asian financial crisis has come to be regarded as a market failure of the kind that, in future, private players must themselves correct and adjust to, without prior expectation or assurance of official bail-outs. Yet, the virtual certainty of future financial crises occurring in the developing world is becoming a new raison d'être for further bolstering the financial and human capacity of MDBs. Such arguments - advanced mainly by the management and staff of MDBs rather than by their developed country shareholders or developing country borrowers - must be seen as opportunistic and false. They are aimed at assuring the continuity of MDBs rather than because developing countries really need them.

1.19 MDBs are now able to mobilise more money on world financial markets than they can prudently lend. At the same time developing countries have financing needs that remain unmet. This paradox arises because most developing countries (especially the poorest in Africa) do not have the creditworthiness to support borrowing from MDB hard-windows. The critical task of arbitraging credit quality between capital markets and low-income countries, which the MDBs used to perform, is now being left undone. Their ability to continue performing that task has been compromised by their own lending excesses in the 1980s when they undertook fast-disbursing and debt refinancing operations they were unfamiliar with. The consequent deficiencies that have emerged in the quality of their asset portfolios since the mid-1980s have compelled them to be more restrained now.

1.20 In addition to the RDBs, three *private* regional finance corporations were created for Africa (SIFIDA), Latin America (ADELA) and Asia (PICA) in the mid-1960s and early-1970s. Commencing with a flourish, these institutions faded into insignificance by the mid-1980s. Their shareholding structures contained no strong single driving force with the motivation or commitment to keeping them afloat when their portfolios were ravaged by the effects of the debt crisis. None of these institutions exists at the present time.

1.21 In a related context, the IADB created an IFC-type of affiliate (the Inter-American Investment Corporation or IIC) in 1983. That affiliate has now been folded back into the IADB. The African and Asian Development Banks did not set up separate affiliates to undertake equity investments or lending to the private sector but undertook these within their own corporate structures through departments which specialised in lending to and investing in the private sector. The AsDB has also invested in the Asian Finance and Investment Corporation (AFIC) with private Asian and Japanese investment banks. The EBRD was unusual in that its Articles of Agreement required it to lend at least 60% of its resources to the private sector in central and Eastern Europe (i.e. transition economies).

1.22 In addition to the *regional* development banks an array of *sub-regional* development banks (SRDBs) has also emerged over the 1960-80 period to support first-generation regional integration arrangements (RIAs) between developing countries in different parts of the world - perhaps nowhere in greater number and less success than in Africa. Without an attempt at exhaustiveness in listing them, they include the:

- European Investment Bank (EIB);
- Caribbean Development Bank (CDB);
- Andean Development Fund (AnDF);
- Central American Bank for Economic Integration (CABEI);
- East African Development Bank (EADB);
- West African Development Bank (WADB);
- Central African Development Bank;
- PTA/COMESA Trade & Development Bank;
- Mahgreb Investment Bank in North Africa; and
- Development Bank for the Southern Pacific Islands in Asia;

1.23 There are also several Arab-funded SRDBs operating in the Middle East and North Africa such as BADEA and the Arab Fund for Social & Economic Development. It is this ***sub-regional*** category of DFI that is of relevance to the SADC case and to this Study.

1.24 The elaborate global structure of DFIs that has developed over the last half-century is depicted in Box 1.A below. At every level, MDBs and DFIs are encountering concerns about their role and capacities, which they are finding difficult to come to terms with. This point is particularly germane when considering the creation of a new SRDB for SADC that raises the same difficult issues, which DFIs at every tier are grappling with.

Box 1.A: DFIs at Various Tiers - Global to National

GLOBAL:	The World Bank (WB)	
REGIONAL:	IADB, AfDB, AsDB, IsDB, EBRD (MEDB)	
SUB-REGIONAL:	CDB, AnDF, CABEI, EADB, WADB, MIB, SPDB, BADEA, Middle East banks	
NATIONAL:	DFIs for	• Industry & Infrastructure • Agriculture & Rural Credit • Small & Medium Enterprise • Micro-enterprise • Housing Finance • Gender Credit

Sector Specialisation of Development Finance (DF) and DFIs

1.25 Development finance did not have a specific sectoral context at the outset. At the apex, both global and regional MDBs operate as multi-sectoral, multi-faceted intermediaries. The World Bank first provided *reconstruction finance* for war-ravaged economies in Europe and Japan between 1947-54. It moved to *infrastructure financing* (power, water supply, transport, and a limited amount of telecommunications) and *industrial financing* (through DFIs) from 1955 onwards. This type of financing was also the mainstay of the RDBs when they were established. In the mid-1960s, MDBs began financing agriculture and rural development. In the 1970s they moved into financing the social sectors targeting poverty alleviation, education, population, health, nutrition, urban development, and environment projects, as well as multi-sector projects and sector-wide programmes.

1.26 To cope with the effects of the debt crisis in the 1980s most of the MDBs switched their focus from financing projects to fast-disbursing loans supporting structural and sectoral adjustment. Effectively this involved financing budget and current account deficits - which also involved financing debt service payments to external creditors including, of course, themselves. That resulted in an overlap between the MDBs and the IMF. In the 1990s the role of the MDBs has shifted yet again to financing: (i) economic transformations in developing countries and in Eastern European economies that became active borrowing members of the MDB system only when the decade began; and (ii) post financial crisis recovery in Asia.

1.27 Although global and regional MDBs have always been multi-sectoral in nature that has not been the case with DFIs at the national level. Within countries, DFIs were usually set up to finance specific sectors: i.e. agriculture and rural finance; industrial and infrastructure finance; construction and housing; small and medium business enterprise (SME) development, etc. Still later, other institutions, as well as credit guarantee funds, rediscount and refinance facilities (operated through the commercial banking system) emerged for financing micro-enterprises (mainly in the service sectors) and gender credit (i.e. loans targeted at women borrowers). Specialised institutions also emerged for the provision of trade and export finance, although these short-term facilities (even though invariably rolled over indefinitely) are rarely classified as ‘development finance’.

1.28 Financing on special terms for all these sectors and activities might be deemed to fall under the same rubric. But, *at the national level, ‘development finance’ has come to be associated specifically with long-term credit for financing productive assets in the industrial and infrastructure sectors; invariably through specialised public or private DFIs set up for that purpose.* In other sectors - especially agricultural and rural credit, SME finance, and housing/mortgage credit - specialised institutions have developed as distinct genres related to, but quite distinct from, DFIs. They differ from the typical DFI in: their lending disciplines and approaches; the size of their loans; the number and characteristics of their borrowers; the nature and quality and risks of their asset portfolios; their collateral requirements; their administrative structures and overhead costs; and the operational, financial and repayment risks that they are exposed to.

1.29 With its specialisation in lending for industry (and occasionally for infrastructure) the typical, national DFI has engaged principally in intermediating *foreign currency* loans. This is not surprising. The capital goods for the projects they financed were invariably imported in the incipient stages of industrialisation of most developing countries. To a lesser extent, DFIs also intermediated domestic currency resources - mainly for financing the permanent working capital requirements associated with large projects. However, as the more successful national DFIs have evolved and transformed the mix has changed towards a greater proportion of domestic currency financing as they, and the financial markets in which they operate, have matured.

1.30 In other sectors, specialised institutions focused on intermediating *domestic* resources. Their requirement for forex funding was much lower. Issues concerning foreign exchange risk (exposure which resulted in rendering most DFIs insolvent in the 1980s) and of adequate domestic currency resource mobilisation have therefore featured more prominently in the risk profiles of DFIs than of institutions operating in other sectors.

1.31 For the purposes of this Study, the term development finance is used in its broadest sense to embrace credit extended to all the sectors identified above. But discussion of a possible sub-regional DFI focuses on the more limited concept of an institution specialising in providing long-term finance for *industrial and infrastructure projects* with sub-regional dimensions. The reason for that is clear. Development finance for agriculture, rural development, SME development, micro-enterprise financing and low-cost housing may well be issues of region-wide concern and of importance to SADC's policy-makers. The intra-regional sharing of information and experience in these areas may well be crucial. But the institutions specialising in these sectors are more likely to be national rather than regional in ownership and scope of operations. On the other hand, *if* the argument for supra-national financing of regional industrial and infrastructure projects is found to be compelling, then the institutions involved in financing them will need to be regional in character or at least embrace regional dimensions for their principal resource mobilisation and allocation functions.

Changes in 'Development Finance' and DFIs: Implications for SADC

1.32 Judgements about the need for development finance and for DFIs could be made with reasonable certainty before 1980. Since then, development finance has been in a state of flux. Reflecting these circumstances, most (if not all) of the successful DFIs in Asia and Latin America have evolved into becoming full service investment banks or universal banks. Some, like the Development Bank of Singapore (DBS), have become diversified financial conglomerates. Their activities transcend universal banking. They now provide virtually every financial service, wholesale and retail, to corporates and individuals. They engage in cutting-edge financial transactions in the developed or developing worlds. Apart from commercial and investment banking, project-financing, and trade financing (regular or structured) they are also involved in derivatives tailoring and trading, asset and fund management, private banking, portfolio management, corporate finance, mergers and acquisitions, commodity financing, securities-broking, forex-trading, capital market activity, property and construction financing, insurance and pension funds etc.

1.33 DFI commercialisation and diversification has occurred rapidly in South Asia, Southeast Asia, East Asia and Latin America. Less successful DFIs (mainly in Africa) have focused exclusively on providing development finance into the 1990s. Many are under severe financial distress. Some have already become defunct. That is not to suggest that the need for development finance or for DFIs in Africa has disappeared. Despite the failure of DFIs on the continent, the need for development finance remains. It will continue to do so until financial systems in Africa develop and become more sophisticated.

1.34 A UN report (1995) on financial systems in Africa, categorised countries as being at three stages: *primary*, *intermediate* and *advanced*. It noted that despite the recent progress achieved in implementing reforms, Africa's financial systems remained at the primary or intermediate stages. Using several indicators - such as the ratio of broad money to GDP, the proportion of savings held in the form of broad money, and the institutions and instruments actively employed - financial systems in 20 of the 41 African countries studied, were classified as being at the primary stage, 19 at the intermediate stage, and only *two* (Mauritius and South Africa) at the advanced stage (Box 1.B).

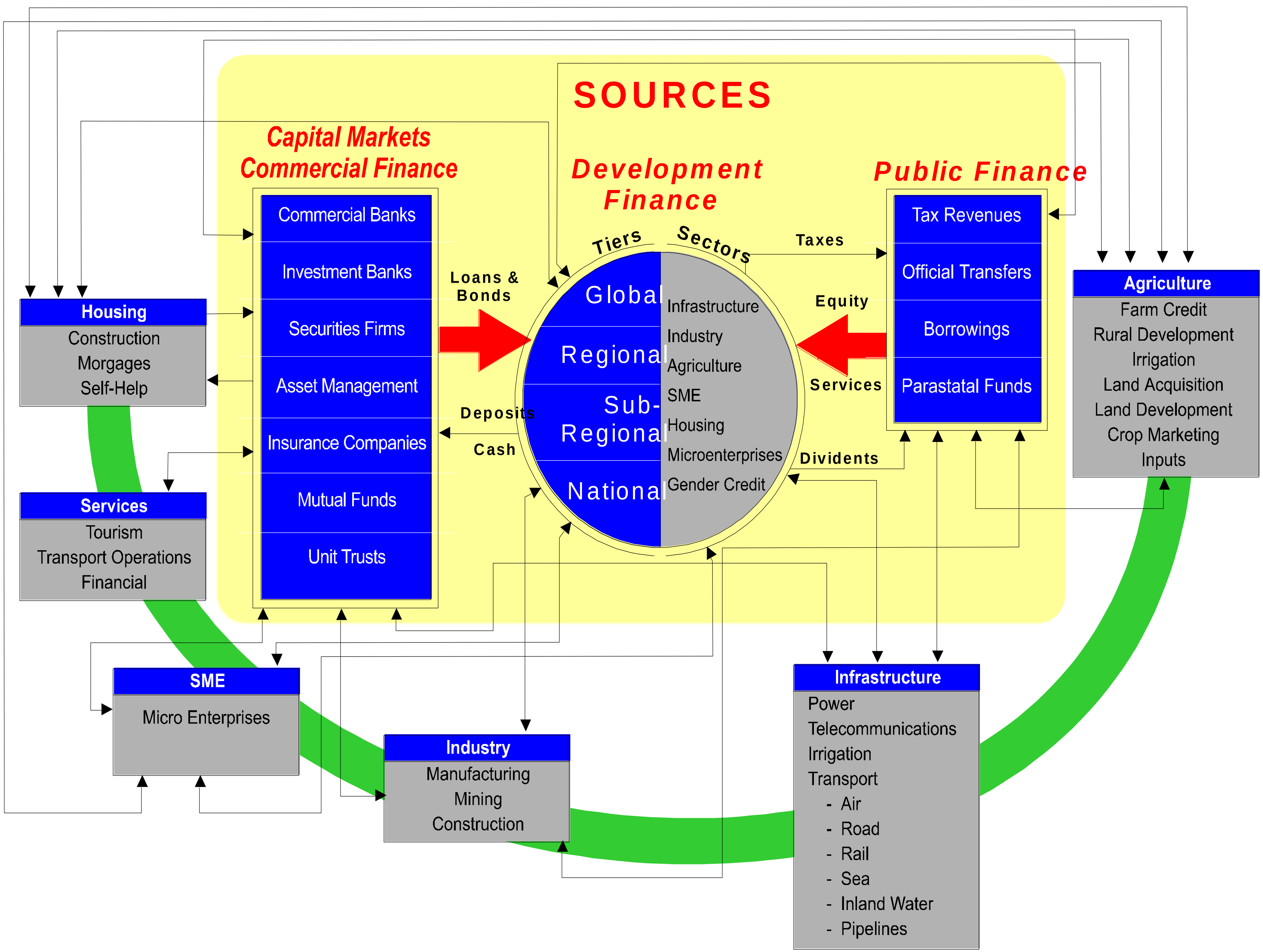
1.35 The need for development finance is, by its very nature, transitional. DFIs were created to compensate for imperfections and gaps in inadequately developed financial systems and capital markets. They were not intended to become permanently enshrined institutional structures. Indeed as countries develop, DFIs begin to outlive their usefulness if they do not transform and grow in tune with the economies in which they are embedded. Those DFIs, which focused on protecting their term-lending turf with special support from the MDBs and their governments, quickly became dysfunctional.

Box 1.B: Africa: Measures of Financial Deepening					
	M2/GDP	M1/GDP	C/GDP	DD/M2	ΔM2/SAVING
Primary Stage					
Benin	0,28	0,22	0,31	0,45	3,2
Burkina Faso	….	….	0,62	0,27	0,34
Burundi	0,18	0,12	…	…	…
Central African Republic		0,16	0,14	0,89	0,16
Chad	0,18	0,17	0,77	0,25	-0,52
Congo	0,22	0,16	0,53	0, 34	0,91
Equatorial Guinea	0,07	0,06	0,43	0,46	0,14
Gabon	0,15	0,09	0,39	0,37	0,22
Guinea	…	…	…	…	…
Guinea Bissau	0,15	0,19	0,66	0,23	…
Madagascar	0,23	0,16	0,35	0,46	3,27
Mali	0,22	0,16	0,56	0,31	0,27
Mauritania	0,27	0,21	0,41	0,43	…
Mozambique	0,12	0,08	…	…	…
Niger	0,20	0,11	0,58	0,30	1,13
Sierra Leone	0,15	0,10	0,60	0,27	0,65
Sudan	0,28	0,23	…	…	…
Togo	…	…	0,32	0,26	1,63
Uganda	0,80	0,06	0,48	…	…
Zaire	0,16	0,14	0,60	…	…
Intermediary Stage					
Algeria	0,59	0,41	0,20	0,30	0,36
Botswana	0,31	0,10	0,27	…	…
Cameroon	0,21	0,14	0,46	0,31	0,29
Cape Verde	0,47	0,29	0,32	0,40	-3,12
Cote d'Ivoire	0,31	0,17	0,54	0,29	…
Djibouti	0,79	0,36	0,30	0,39	…
Ethiopia	0,64	0,44	0,65	0,25	-17,06
Gambia	0,22	0,13	0,48	0,32	-2,22
Ghana	0,17	0,12	0,49	0,35	2,22
Kenya	0,72	…	0,37	0,21	0,51
Lesotho	0,35	0,17	0,11	0,41	-0,07
Malawi	0,22	0,11	0,40	0,29	1,34
Morocco	0,60	0,45	0,15	0,50	0,27
Namibia	0,37	0,18	…	…	…
Nigeria	0,27	0,15	0,38	0,31	0,36
Senegal	0,23	0,16	0,48	0,30	0,12
Seychelles	0,41	0,13	0,41	0,17	0,34
Swaziland	0,32	0,09	0,24	0,21	0,25
Tunisia	0,46	0,20	0,08	0,25	0,47
Tanzania	0,41	0,28	0,51	0,32	0,10
Zambia	0,22	0,10	…	0,28	0,18
Zimbabwe	1,02	…	0,24	0,22	0,50
Advanced Stage					
Egypt	0,80	0,22	0,11	0,10	0,80
Mauritius	0,74	0,13	0,55	0,11	0,47
South Africa	0,75	…	…	…	1,12

Source: International Monetary Fund International Financial Statistics, various issues.

C = Currency, DD = Demand Deposits, M1 = Currency + Demand Deposits, M2 = M1 + Time Deposits, ΔM2 = Changes in M2

Fig 1.A The role of development Finance



1.36 On the other hand, those that survived saw their privileged, special status as monopoly providers of long-term finance for industry as a short-lived aberration. They adapted and competed with other financial institutions (domestic and foreign) in expanding and improving their range of services, products and clients. Concomitantly, they transformed their resource mobilisation and allocation activities even as they contributed to the development of financial systems and capital markets in which they operated. That lesson from global experience has important implications for DFIs and for their future evolution in Africa with SADC being no exception. In a rapidly changing world, it holds true for all DFIs - whether global, regional or sub-regional.

1.37 *Another lesson of global experience is that the specific type (and capacity) of DFI that is needed has to be defined by the initial conditions and evolving needs of the environment in which it must operate.* Contrary to the earlier thinking of the World Bank, which attempted to propagate a standard DFI model around the world between 1955-80, experience suggests that there is no generic institutional answer which applies to every country or sub-regional situation. Whether the need for such intermediaries (however they are constructed) is best met at the regional, sub-regional or national level and whether DFIs should be general-purpose or sector-specialised are explored more fully later in this report in the specific context of SADC.

1.38 With these comments in mind, it needs to be emphasised again that, *in the 1990s, there is neither consensus on, nor clarity about, what 'development finance' means in a generic sense.* There is doubt about whether it is even desirable; except perhaps in highly context-specific and well-defined *project-financing* circumstances. It is no longer clear where the borders of *development finance* lie. They are squeezed between the changing boundaries of *public finance* on one side and *private commercial finance* on the other. It is even less clear whether specialised DFIs are needed for dispensing it.

1.39 There are four sets of reasons explaining why notions about development finance and the role of DFIs are undergoing fundamental re-examination. Each of these is elaborated upon in the next four sections of this chapter:

- experience with DF and DFIs in the past;
- post-1990 developments in global capital markets;
- constraints on public finance; and
- increasing privatisation with a reduction in the participatory role of the state in the market.

1.40 What is clearer now, at least in theory, is that perceived needs for development finance are indicative of transitional imperfections and gaps in *domestic* capital markets and in the risk perceptions of *international* markets at any point in time. These elements do not automatically suggest that a DFI is required. They are symptomatic of frictional losses in costs of financing and risk management as well as of information imperfections and asymmetries resulting in variations between risks perceived, and those actually involved, in making investments. Shortcomings in financial systems make private sources of finance reluctant to bear - fully or partially - all of these risks (political, commercial, country, transfer, maturity-transformation etc.) in difficult country environments or in the case of complex, long-gestating infrastructure projects even in developed countries.

1.41 But, market imperfections, information asymmetries and frictional losses are neither permanent nor immutable. They undergo changes continually as the large annual increases in private flows to the developing world since 1990 demonstrate. Such imperfections and costs can be expected, with increasing regionalisation and globalisation of financial systems, to diminish over time. Exogenous influences force domestic markets to develop with improvements in the quality and timeliness of information available to markets. That explains why the notion of development finance itself is subject to such flux.

The Declining Importance of Development Finance and of DFIs

1.42 Apart from a better theoretical understanding of what went wrong and why, there are practical reasons for post-1980s scepticism about the efficacy of development finance. It is not just that DF and DFIs (whether regional, sub-regional or national) have become unfashionable. Africa's experience with DFIs suggests that they have become part of the problem, not the solution, in meeting its development financing needs. That experience, confirmed by the findings of World Bank reviews, needs to be taken into account in assessing the problems that a new SRDB in SADC would confront.

1.43 The general picture for African DFIs is characterised by the following impressions and conclusions:

- DFIs have been subject to *political influence* resulting in credit diversion and the subordination of efficiency and profitability objectives to political priorities. Credit provided through DFIs has often been redirected from intended beneficiaries to influential borrowers often resulting in resource misdirection and misallocation.

- Subsidies on the cost of funds on-lent by DFIs, together with substantial losses on *non-performing assets*, have strained government budgets to keep national DFIs liquid and solvent. That has compromised efforts to achieve monetary and fiscal control in unstable economic environments

- In Africa, DFI operations have often aggravated rather than corrected the inadequacies of local banking and financial systems. They have resulted in lower levels of financial intermediation and contributed (along with other macroeconomic policies) to *obstructing capital market development*.

- DFI lending in SSA may also have contributed negatively to growth and income distribution. By directing credit to parastatals and the subsidiaries of multinationals, DFIs have crowded out more efficient smaller private firms from formal credit markets, forcing them to rely on retained earnings or borrowing from informal markets at exorbitant cost.

- By allocating resources on the basis of fiat rather than market signals DFIs failed in allocating credit productively. African DFIs (with the exception of South Africa) have had weak financial structures, poor management, and constrained portfolio choice resulting from the economic policies pursued by governments (which is true even of South African DFIs). Their lending operations directed scarce forex resources and long-term credit to public enterprises whose poor financial and operating performance resulted in contaminating their portfolios.

- The majority of DFI assets in Africa are non-performing. Erosion of financial discipline and resource misallocation have rendered most African DFIs effectively insolvent. They were ineffective in mobilising domestic resources relying instead on foreign currency resources provided by MDBs. Their project appraisal, monitoring and supervision capabilities proved inadequate. Along with the political interventions they were subjected to, that resulted in adverse project selection, inadequate sectoral diversification and over-concentration in particular industries.

- DFI portfolios in Africa were over-exposed to cyclical risk, and default risk because of the excessively leveraged financial structures of the enterprises/projects they financed. Their indirect exposure to exchange risk proved to be debilitating. This risk was supposedly passed on to their borrowers. But the inability of borrowers to cope with the effects of spiral devaluations in markets, which provided no forward cover or hedging instruments, resulted in large-scale arrears and defaults.

- There is a growing conviction in the international community that regional DFIs (e.g. the EBRD and the proposed MEDB) are being advocated for *political* rather than for technically sound economic or financial reasons. Such DFIs invariably become costly political symbols of intra-regional solidarity rather than being efficient and effective vehicles for mobilising and allocating financial resources. There is a risk that, an RDB/F for SADC will be perceived in the same way.

- The MDBs have effectively withdrawn from propagating and financing new national or sub-regional DFIs. Disenchanted with the poor performance and failure of DFIs, they are now focusing on broader financial system and capital market development through private sector initiatives and investment to facilitate more rapid regionalisation and globalisation of integrated financial systems.

The Growing Dominance of Capital Markets in Financing Development

1.44 The foregoing paragraph has elaborated on the experience of development financing in Africa over the last quarter-century to suggest why notions of DF and DFIs are undergoing change. But these negative reasons apart, there are also *positive* exogenous developments reinforcing a re-examination of the need for development finance. These concern the impressive growth of *private capital flows* (FDI and FPI) to developing countries. Such flows now dwarf official financial flows and funds raised by DFIs.

1.45 This development compels consideration of the choice between: (i) efforts focused on more forward-looking private sector initiatives aimed at linking Africa's financial markets with global sources of market funding for financing regional projects; or (ii) establishing a new SRDB with public funding to achieve the same objective. These are not mutually exclusive alternatives. But they call for an indication of clear priorities in a situation of constrained public funding availability. This choice also raises the question of whether development financing needs to be relied on in the interim, i.e. until SADC's capital markets have become more regionally and globally integrated and more efficient mobilisers of investment capital for the region and for regional projects.

1.46 What has been happening since 1990 in pushing outward the frontiers of private commercial finance was beyond contemplation even in 1989. As a result, earlier presumptions about the willingness (and limitations) of private firms operating in global markets to undertake development financing risks - along with doubts about their ability to assess properly the costs/benefits of doing so, especially in comparison with specialised DFIs - have had to undergo profound reconsideration. A few points are worth making to emphasise what the future holds:

- Net private capital flows (FDI+FPI+CBL) to the developing world exceeded US$299 billion in 1997; *seven times as large* as such flows were (about US$44 billion) in 1990. Though these flows fell to US$227 billion in 1998 as a consequence of financial crises in Asia, Russia and Brazil they are expected to recover in the new millennium.

- In 1997 private capital flows to developing countries were *eight times* the size of official flows (US$39bn) while in 1998 that multiple was reduced to five as private flows fell and official flows increased. In 1990, official flows (US$57bn) were larger than private flows (US$44bn).

- In 1990, developing countries absorbed 15% of global **FDI** (foreign direct investment) flows. In 1997 their share was over 40%.

- Developing countries accounted for less than 2% of global **FPI** (portfolio) flows in 1990. In 1996, their share was over 33%.

- In 1990, private flows financed 4% of gross domestic investment (GDI) in the developing world. In 1996 they financed 20% of GDI.

- Commercial bank lending (CBL) is now dwarfed by FDI and FPI in the composition of private flows. This is changing the cash flow risk profile of the external liabilities of developing countries.

- Private firms are now the principal beneficiaries (recipients) of external capital flows. The public sector absorbs 80-90% of official external flows, but absorbs under 20% of private flows.

- Contrary to expectations, private flows have proven to be robust and resilient even in the face of major political and economic shocks. Private capital has continued to flow to developing countries despite disruptive global events like the rise in US interest rates in 1994, recession in Europe in 1990-94, the Mexican crisis of 1994-95, the various Indian mini-crises which occurred between 1994-97, the large South African devaluation of 1996, and the Asian, Russian and Brazilian crises of 1997-98.

- The volume of private flows and the shift in their composition from bank loans to FDI and FPI is forcing rapid globalisation and integration of developing country financial markets.

- Technological change and financial innovation will continue to reduce costs for cross-border financial transactions and make developing country markets more accessible.

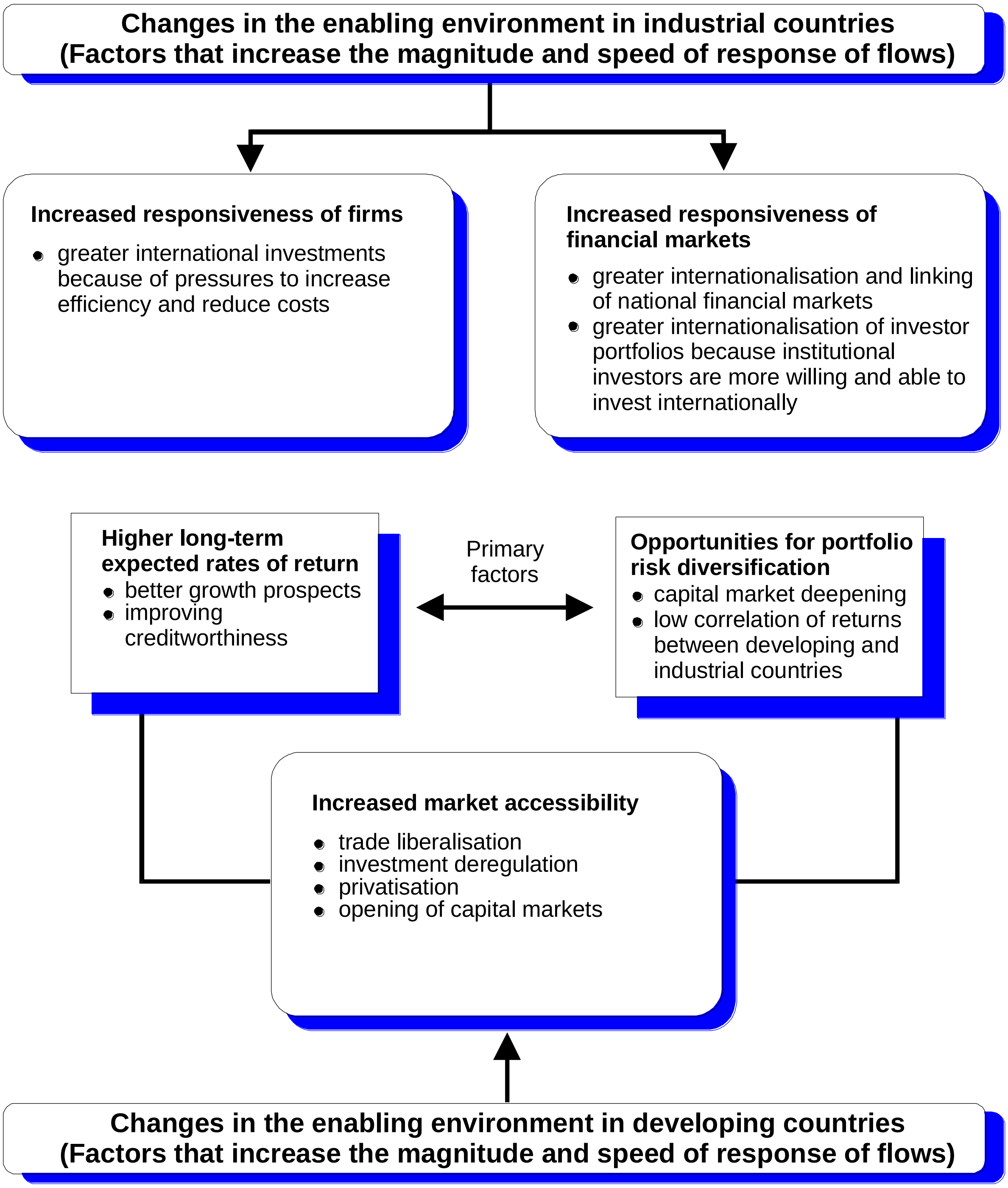
- Continuing financial deregulation, the entry of global financial firms into developing country financial markets, and competitive pressures in the financial industry will lead to further attempts on the part of global institutional investors to maximise returns and to diversify global risk exposure.

- With continuing economic liberalisation, financial system deregulation and further privatisation there will be further movement toward achieving equilibrium between the distribution of global productive capacity and the distribution of financial claims on productive assets. At present developing countries account for nearly 55% of global productive capacity but only 15% of market capitalisation.

- Markedly different demographics - i.e. differences in the age-distributions of populations in the developed and developing worlds - will continue to impel the long-term movement of private investment capital from the developed to the developing world.

- Developing countries themselves are becoming major sources of private investment, a trend which will accelerate in coming years. Firms from Korea, Taiwan, Malaysia, Brazil, China, Chile, Thailand, and India are generating outflows of FDI in their search for securing long-term sources of minerals and other raw materials - a trend from which Africa should benefit. Firms in high cost Asian countries are also moving abroad to lower labour costs; a trend that Africa will not capitalise on until productivity-adjusted wage rates are lowered to internationally competitive levels.

Fig 1.B Structural forces driving private capital to developing countries



Source: IFC

Table 1.A Aggregate net long-term resource flows to developing countries, 1990-96

(Billions of US Dollars)

Type of flow	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
Aggregate net resource flows	**100.6**	**122.5**	**146.0**	**212.0**	**207.0**	**237.2**	**284.6**
Official development finance	***56.3***	***65.6***	***55.4***	***55.0***	***45.7***	***53.0***	***40.8***
Grants	29.2	37.3	31.6	29.3	32.4	32.6	31.3
Loans	27.1	28.3	23.9	25.7	13.2	20.4	9.5
Bilateral	*11.6*	*13.3*	*11.3*	*10.3*	*2.9*	*9.4*	*-5.6*
Multilateral	*15.5*	*15.0*	*12.5*	*15.4*	*10.3*	*11.1*	*15.0*
Total private flows	***44.4***	***56.9***	***90.6***	***157.1***	***161.3***	***184.2***	***243.8***
Debt flows	16.6	16.2	35.9	44.9	44.9	56.6	88.6
Commercial banks	*3.0*	*2.8*	*12.5*	*-0.3*	*11.0*	*26.5*	*34.2*
Bonds	*2.3*	*10.1*	*9.9*	*35.9*	*29.3*	*28.5*	*46.1*
Others	*11.3*	*3.3*	*13.5*	*9.2*	*4.6*	*1.7*	*8.3*
Foreign direct investment	24.5	33.5	43.6	67.2	83.7	95.5	109.5
Portfolio equity flows	3.2	7.2	11.0	45.0	32.7	32.1	45.7

Source : World Bank Debtor Reporting System

Table 1.B Aggregate net long-term resource flows to SADC countries, 1990-96

(Millions of US Dollars)

Type of flow	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
Aggregate net resource flows	**4408.8**	**4642.1**	**5134.6**	**4613.7**	**3399.3**	**974.6**	-
Official development finance	***3681.3***	***3668.8***	***4246.0***	***3717.3***	***2911.2***	***678.8***	-
Grants	2892.4	2794.3	3076.2	2578.1	2129.0	80.6	-
Loans	788.9	874.5	1169.8	1139.2	782.2	598.2	-
Bilateral	*355.4*	*253.5*	*222.7*	*110.5*	*34.7*	*-34.8*	-
Multilateral	*433.5*	*621.0*	*947.1*	*1028.7*	*747.5*	*633.0*	-
Total private flows	***727.5***	***973.3***	***888.6***	***896.4***	***488.1***	***295.8***	-
Debt flows	670.5	150.3	401.6	471.4	130.1	271.8	-
Commercial banks	*120.0*	*63.1*	*109.7*	*-35.2*	*272.6*	*605.4*	-
Bonds	*-30.0*	*-27.0*	*-52.0*	*-30.0*	*-30.0*	*-30.0*	-
Others	*280.5*	*114.2*	*343.9*	*536.6*	*-112.5*	*-303.6*	-
Foreign direct investment	57.0	832.0	487.0	238.0	298.0	24.0	-
Portfolio equity flows	0.0	0.0	0.0	187.0	60.0	0.0	-

Source : World Bank Debtor Reporting System

Table 1.C Capital flows to developing countries, 1990-95

(Billions of US Dollars)

	1990	1991	1992	1993	1994	1995
All developing countries						
Total net capital inflows 1/	35.5	154.4	130.1	172.9	151.6	193.7
Foreign direct investment plus portfolio investment (net)	36.9	65.3	78.8	138.5	111.7	108.6
Net foreign direct investment	18.6	28.4	31.6	48.9	61.3	71.7
Net portfolio investment	18.3	36.9	47.2	89.6	50.4	37.0
Other 2/	-1.4	89.1	51.3	34.5	39.8	85.1
Of which: Net credit and loans from IMF	-1.9	1.1	-0.2	-0.1	-0.8	12.2
Africa						
Total net capital inflows 1/	2.0	3.5	2.7	7.2	13.4	12.6
Foreign direct investment plus portfolio investment (net)	1.1	1.1	1.6	0.3	3.3	2.2
Net foreign direct investment	1.4	1.6	2.6	1.2	2.2	2.1
Net portfolio investment	-0.2	-0.5	-1.0	-0.9	1.1	0.1
Other 2/	0.8	2.4	1.1	6.9	10.1	10.4
Of which: Net credit and loans from IMF	-0.6	0.2	-0.2	0.2	0.9	0.8
Asia						
Total net capital inflows 1/	23.1	49.8	32.1	70.5	81.1	104.1
Foreign direct investment plus portfolio investment (net)	8.5	17.2	24.2	56.5	57.9	70.9
Net foreign direct investment	9.4	14.3	14.4	32.7	41.9	52.4
Net portfolio investment	-0.9	2.9	9.8	23.8	16.0	18.5
Other 2/	14.6	32.6	7.9	14.0	23.1	33.2
Of which: Net credit and loans from IMF	-2.4	1.9	1.3	0.6	-0.8	-1.8
Middle East						
Total net capital inflows 1/	-8.1	78.1	42.2	31.9	9.9	15.1
Foreign direct investment plus portfolio investment (net)	3.3	24.5	22.4	16.3	15.4	8.4
Net foreign direct investment	1.2	1.3	1.8	1.1	-0.5	0.0
Net portfolio investment	2.1	23.2	20.6	15.1	15.9	8.4
Other 2/	-11.4	53.6	19.9	15.6	-5.5	6.7
Of which: Net credit and loans from IMF	-0.1	0.0	0.4	0.0	0.4	0.3
Latin America						
Total net capital inflows 1/	18.5	23.0	53.1	63.4	47.2	61.8
Foreign direct investment plus portfolio investment (net)	24.0	22.5	30.7	65.5	35.1	27.2
Net foreign direct investment	6.6	11.2	12.8	13.9	17.7	17.1
Net portfolio investment	17.4	11.4	17.8	51.6	17.4	10.0
Other 2/	-5.5	0.5	22.5	-2.1	12.1	34.7
Of which: Net credit and loans from IMF	1.2	-1.0	-1.6	-0.9	-1.3	12.9
Memorandum Items						
All developing countries						
Total net capital inflows 1/	11.9	-0.5	5.0	10.9	13.6	34.4
Foreign direct investment plus portfolio investment (net)	0.0	3.2	3.3	8.8	8.5	17.3
Net foreign direct investment	0.0	2.4	4.2	6.0	5.6	11.4
Net portfolio investment		0.8	-0.8	2.7	3.0	6.0
Other 2/	11.9	-3.7	1.7	2.1	5.1	17.1
Of which: Net credit and loans from IMF	0.3	2.4	1.6	3.7	2.4	4.7

Source: International Monetary Fund, World Economic Outlook Data Base.

1/ Not including reserve assets

2 / Short- and Long-term credits; loan (including use of Fund credit); currency and deposits; and other accounts receivable and payable

Table 1.D Net Official Flows of DF to developing countries, 1990-96

(Billions of US Dollars)

Category	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
Official development finance	**56.3**	**65.6**	**55.4**	**55.0**	**45.7**	**53.0**	**40.8**
Concessional finance	***43.9***	***53.3***	***46.1***	***43.4***	***46.7***	***45.2***	***44.4***
Grants	29.2	37.3	31.6	29.3	32.4	32.6	31.3
Loans	14.8	15.9	14.6	14.2	14.3	12.6	13.1
Bilateral	*8.7*	*9.2*	*7.4*	*7.3*	*6.0*	*4.8*	*4.8*
Multilateral	*6.1*	*6.7*	*7.2*	*6.9*	*8.3*	*7.8*	*8.3*
Nonconcessional finance	***12.3***	***12.4***	***9.3***	***11.5***	***-1.1***	***7.8***	***-3.6***
Bilateral	*2.9*	*4.1*	*3.9*	*3.1*	*-3.1*	*4.6*	*-10.4*
Multilateral	*9.4*	*8.3*	*5.4*	*8.4*	*2.0*	*3.2*	*6.8*
Memo items							
Use of IMF credit	0.1	3.2	1.2	1.6	1.6	16.8	0.6
Technical cooperation grants	14.2	15.7	17.9	18.5	17.4	20.7	20.0

Source: World Bank Debtor Reporting System

Table 1.E Net Official Flows of DF to SADC countries, 1990-96

(Millions of US Dollars)

Category	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
Official development finance	**3681.3**	**3668.8**	**4246.0**	**3717.3**	**2911.2**	**678.8**	-
Concessional finance	***3670.9***	***3810.9***	***4177.6***	***3532.8***	***3100.2***	***952.9***	-
Grants	2892.4	2794.3	3076.2	2578.1	2129.0	80.6	-
Loans	778.5	1016.6	1101.4	954.7	971.2	872.3	-
Bilateral	*313.2*	*277.1*	*256.0*	*127.0*	*66.8*	*60.1*	-
Multilateral	*465.3*	*739.5*	*845.4*	*827.7*	*904.4*	*812.2*	-
Nonconcessional finance	***10.4***	***-142.1***	***68.4***	***184.5***	***-189.0***	***-274.1***	-
Bilateral	*42.2*	*-23.6*	*-33.3*	*-16.5*	*-32.1*	*-94.9*	-
Multilateral	*-31.8*	*-118.5*	*101.7*	*201.0*	*-156.9*	*-179.2*	-
Memo items							
Use of IMF credit	1906.1	1873.4	2065.9	1901.2	1875.3	357.6	-
Technical cooperation grants	841.6	949.8	1128.4	1130.8	881.8	62.3	-

Source: World Bank Debtor Reporting System

Figure 1.C Private capital flows to developing countries, 1975-96

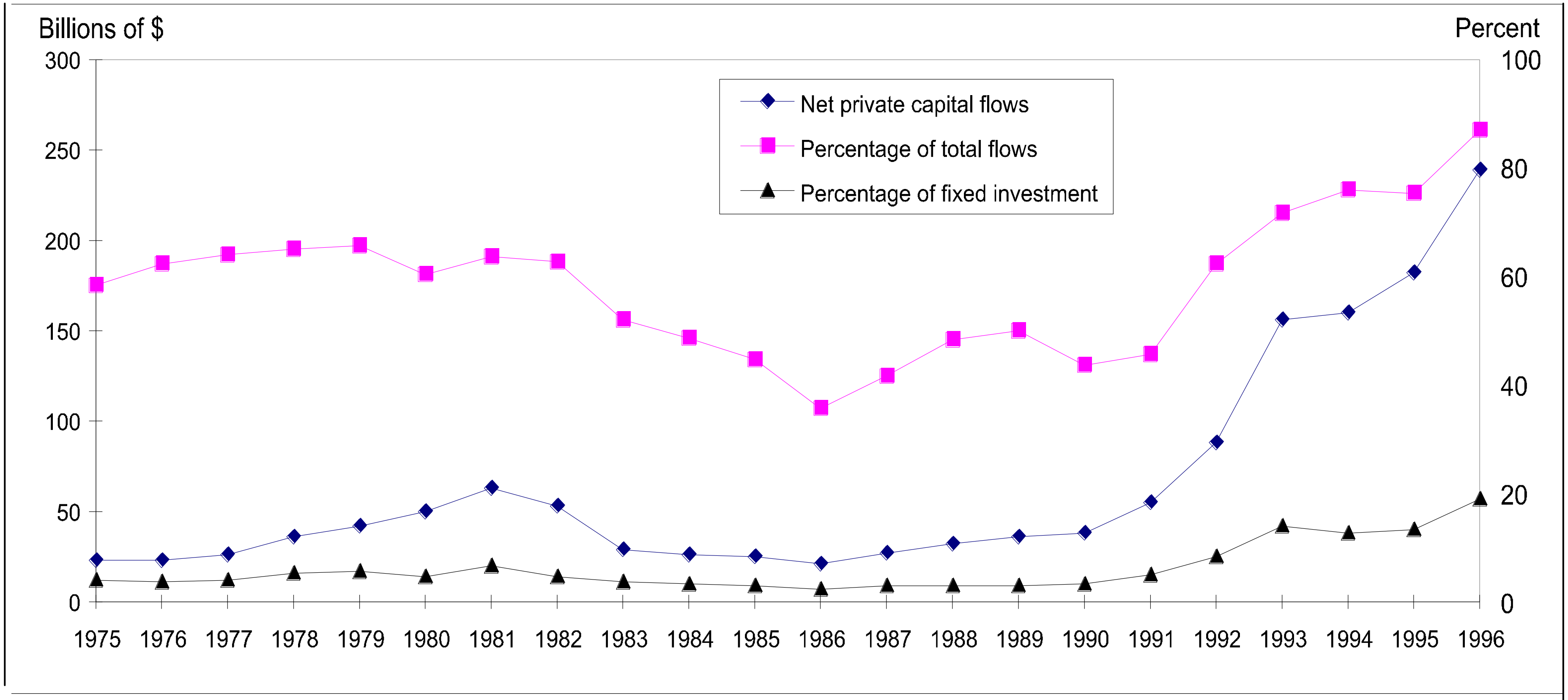
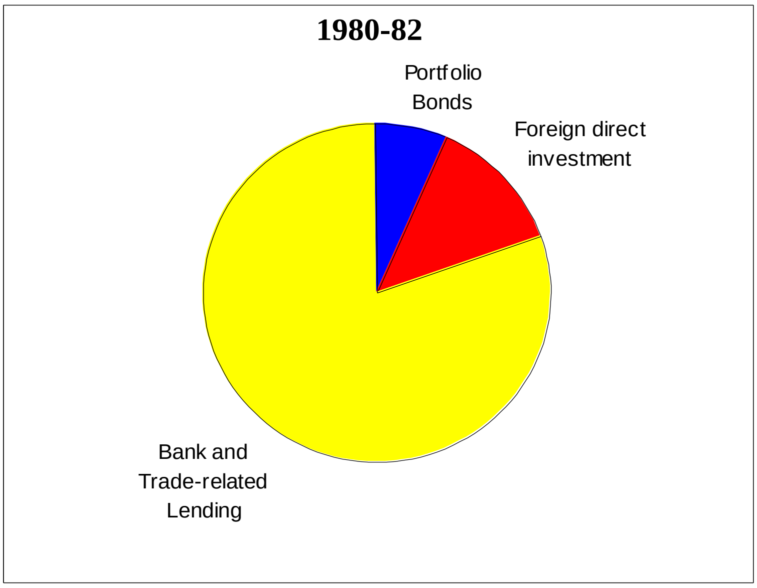


Figure 1.C Composition of Net Private Capital Flows to Developing Countries, 1980-82 and 1995-96



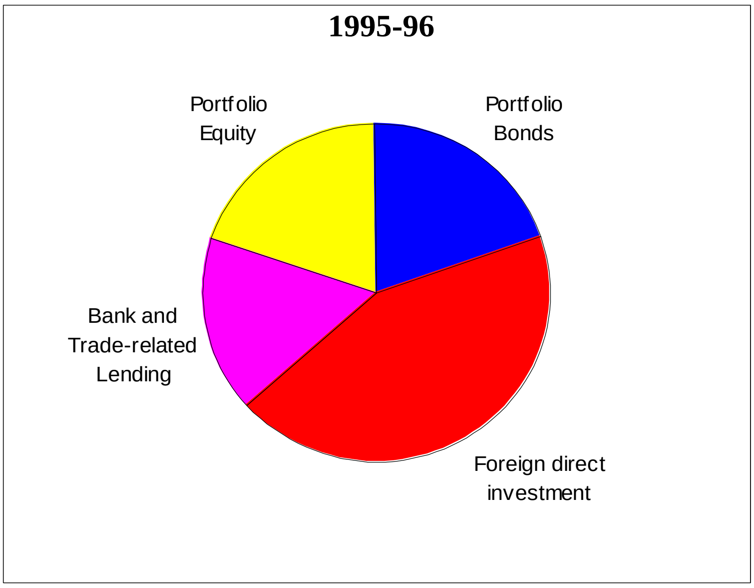


Table 1.F Aggregate net private capital flows to developing countries, 1990-96

(Billions of US Dollars)

Type of flow	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
Total private flows	**44.4**	**56.9**	**90.6**	**157.1**	**161.3**	**184.2**	**243.8**
Portfolio flows	5.5	17.3	20.9	80.9	62.0	60.6	91.8
Bonds	2.3	10.1	9.9	35.9	29.3	28.5	46.1
Equity	3.2	7.2	11.0	45.0	32.7	32.1	45.7
Foreign direct investment	24.5	33.5	43.6	67.2	83.7	95.5	109.5
Commercial banks	3.0	2.8	12.5	-0.3	11.0	26.5	34.2
Others	11.3	3.3	13.5	9.2	4.6	1.7	8.3
Memo Items							
Aggregate net resource flows	100.6	122.5	146.0	212.0	207.0	237.2	284.6
Private flows' share (percent)	44.1	46.4	62.1	74.1	77.9	77.7	85.7

Source: World Bank debtor reporting system

Table 1.G Aggregate net private capital flows to SADC countries, 1990-96

(Millions of US Dollars)

Type of flow	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
Total private flows	**727.5**	**973.3**	**888.6**	**896.4**	**488.1**	**295.8**	-
Portfolio flows	-30.0	-27.0	-52.0	157.0	30.0	-30.0	-
Bonds	-30.0	-27.0	-52.0	-30.0	-30.0	-30.0	-
Equity	0.0	0.0	0.0	187.0	60.0	0.0	-
Foreign direct investment	57.0	823.0	487.0	238.0	298.0	24.0	-
Commercial banks	120.0	63.1	109.7	-35.2	272.6	605.4	-
Others	580.5	114.2	343.9	536.6	-112.5	-303.6	-
Memo Items							
Aggregate net resource flows	4408.8	4642.1	5134.6	4613.7	3399.3	974.6	-
Private flows' share (percent)	16.5	20.9	17.3	19.4	14.4	30.4	-

Source: World Bank debtor reporting system

Figure 1.E Composition of private capital flows by region

Percentage of GNP

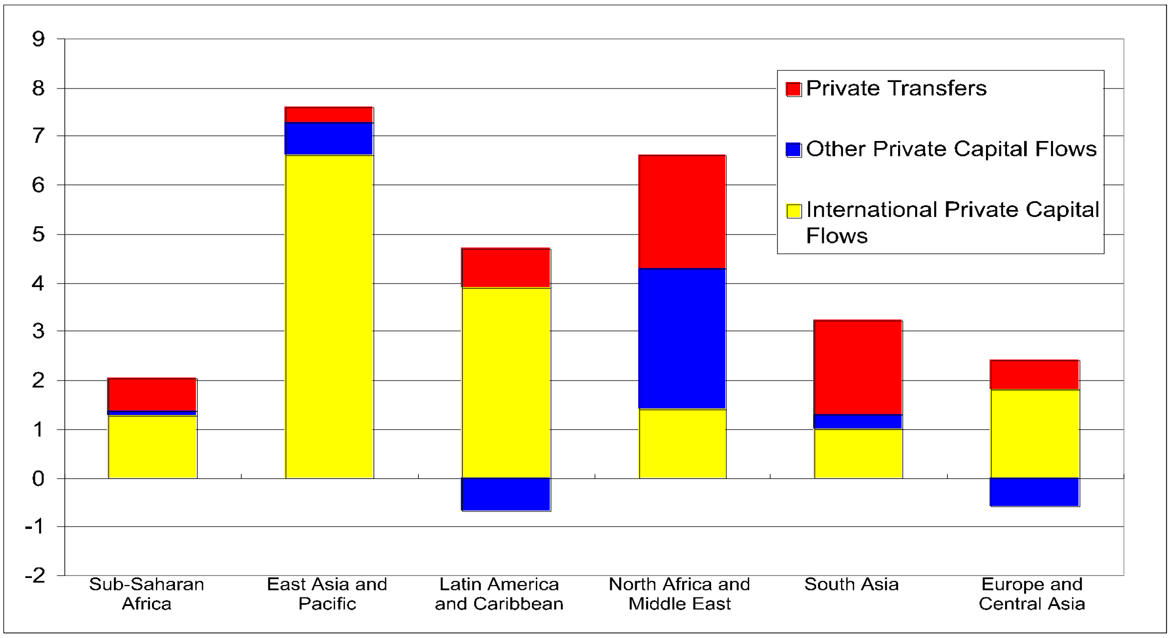


Table 1.H Aggregate net resource flows (Long-term) to SADC Countries

(Millions of US Dollars)

Country	Aggregate net resource flows (excl IMF) Annual average 1990-94	1995	Private flows: Foreign Direct Investment Annual average 1990-94	1995	Portfolio Equity Annual average 1990-94	1995	Bonds Annual average 1990-94	1995	Bank and Trade related lending Annual average 1990-94	1995	Official flows (including grants) Annual average 1990-94	1995
1 Angola	894	891	254	400	0	0	0	0	375	123	265	368
2 Botswana	28	100	-43	70	0	0	0	0	1	-6	70	36
3 Lesotho	115	123	12	23	0	0	0	0	-3	9	106	91
4 Malawi	349	319	0	1	0	0	0	0	-7	-15	356	333
5 Mauritius	103	309	22	15	6	4	0	150	44	135	31	5
6 Mozambique	901	1001	24	36	0	0	0	0	1	28	877	937
7 Namibia	na	na	na	na	na	na	na	na	na	na	na	na
8 South Africa	na	na	na	na	na	na	na	na	na	na	na	na
9 Swaziland	82	74	68	58	0	0	0	0	-2	0	15	16
10 Tanzania	887	747	16	150	0	0	0	0	0	-13	871	610
11 Zambia	701	482	80	66	0	0	0	0	-27	-36	648	452
12 Zimbabwe	479	450	14	40	10	18	-34	-30	17	71	472	351

Source : World Bank Debtor Reporting System

Table 1.I Net private capital flows to developing countries (1990-1996)

(Billions of US Dollars)

Country group or Country	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
All developing countries	44.4	56.9	90.6	157.1	161.3	184.2	243.8
Sub-Saharan Africa	0.3	0.8	-0.3	-0.5	5.2	9.1	11.8
East Asia and the Pacific	19.3	20.8	36.9	62.4	71.0	84.1	108.7
South Asia	2.2	1.9	2.9	6.0	8.5	5.2	10.7
Europe and Central Asia	9.5	7.9	21.8	25.6	17.2	30.1	31.2
Latin America and the Caribbean	12.5	22.9	28.7	59.8	53.6	54.3	74.3
Middle East and North Africa	0.6	2.2	0.5	3.9	5.8	1.4	6.9
Income Group							
Low-income countries	11.4	12.1	25.4	50.0	57.1	53.4	67.1
Middle-income countries	32.0	44.0	64.8	107.1	104.2	130.7	176.7
Top country destinations							
China	8.1	7.5	21.3	39.6	44.4	44.3	52.0
Mexico	8.2	12.0	9.2	21.2	20.7	13.1	28.1
Brazil	0.5	3.6	9.8	16.1	12.2	19.1	14.7
Malaysia	1.8	4.2	6.0	11.3	8.9	11.9	16.0
Indonesia	3.2	3.4	4.6	1.1	7.7	11.6	17.9
Thailand	4.5	5.0	4.3	6.8	4.8	9.1	13.3
Argentina	-0.2	2.9	4.2	13.8	7.6	7.2	11.3
India	1.9	1.6	1.7	4.6	6.4	3.6	8.0
Russia	5.6	0.2	10.8	3.1	0.3	1.1	3.6
Turkey	1.7	1.1	4.5	7.6	1.6	2.0	4.7
Chile	2.1	1.2	1.6	2.2	4.3	4.2	4.6
Hungary	-0.3	1.0	1.2	4.7	2.8	7.8	2.5
Percentage share of top 12 countries	***83.6***	***76.8***	***87.4***	***84.1***	***75.4***	***73.3***	***72.5***

Source: World Bank Debtor Reporting System.

Note: Private flows include commercial bank lending guaranteed by export credit agencies.
Country ranking is based on cumulative 1990-1995 private capital flows received.
Private flows include commercial bank export credit agencies.

Table 1.J Gross portfolio flows to developing countries, by region (1990-96)
(Billions of US Dollars)

Region	1990	1991	1992	1993	1994	1995	1996
All developing countries	**8.5**	**17.8**	**34.1**	**94.6**	**78.1**	**80.9**	**134.3**
Debt	5.3	10.6	23.1	49.6	45.4	48.8	88.6
Equity	3.2	7.2	11.0	45.0	32.7	32.1	45.7
Sub-Saharan Africa	**0.0**	**0.0**	**0.9**	**0.2**	**2.3**	**6.4**	**5.2**
Debt	0.0	0.0	0.7	0.0	1.4	1.5	1.7
Equity	0.0	0.0	0.1	0.2	0.9	4.9	3.5
East Asia and the Pacific	**2.3**	**1.5**	**4.4**	**23.6**	**25.4**	**26.9**	**35.7**
Debt	0.6	0.8	2.3	8.9	15.3	12.2	22.8
Equity	1.7	0.7	2.1	14.6	10.1	14.7	12.9
South Asia	**0.4**	**0.2**	**0.4**	**2.6**	**7.3**	**3.1**	**6.9**
Debt	0.3	0.2	0.0	0.6	1.1	0.8	1.5
Equity	0.1	0.0	0.4	2.0	6.2	2.3	5.4
Europe and Central Asia	**1.9**	**0.8**	**7.5**	**14.6**	**9.8**	**12.2**	**18.9**
Debt	1.6	0.8	7.5	13.6	7.5	9.4	12.2
Equity	0.2	0.0	0.1	1.0	2.3	2.8	6.7
Latin America and the Caribbean	**3.8**	**15.0**	**20.8**	**53.7**	**32.6**	**31.0**	**65.9**
Debt	2.7	8.7	12.6	26.5	19.5	23.8	49.4
Equity	1.1	6.2	8.2	27.2	13.2	7.2	16.5
Middle East and North Africa	**0.1**	**0.0**	**0.0**	**0.0**	**0.8**	**1.2**	**1.7**
Debt	0.1	0.0	0.0	0.0	0.7	1.0	1.0
Equity	0.0	0.0	0.0	0.0	0.1	0.2	0.7

Note: Portfolio debt figures refer to gross capital raised by developing countries through international bonds, certificates of deposit, and commercial paper issues. Portfolio equity refers to gross funds raised through international equity issues and net foreign investments in local equity markets.

Source: Euromoney Bondware, Micropal, central banks, national stock and securities exchanges, various market sources, and World Bank staff estimates based on net asset value of stocks of investment funds adjusted for price movements in individual equity markets.

Table 1.K Foreign investments in local equity markets of developing countries, 1995-96
(Millions of US Dollars)

Region and country	1995	1996 trend	Region and country	1995	1996 trend
All developing countries	**23357**				
Sub-Saharan Africa	4475	downward	East Asia and the Pacific	8398	upward
South Africa	4240	downward	Indonesia	2749	upward
Ghana	204	downward	China	2141	downward
Zimbabwe	18	downward	Thailand	1519	downward
Nigeria	6	downward	Malaysia	1049	upward
Mauritius	4	downward	Philippines	770	upward
Other	3	upward	Vietnam	155	upward
			Other	16	downward
South Asia	2059	upward	Middle East and North Africa	168	upward
India	1243	upward	Morocco	150	upward
Pakistan	729	downward	Jordan	11	upward
Sri Lanka	61	upward	Oman	5	upward
Bangladesh	26	upward	Egypt	2	upward
			Other	1	upward
Latin America and the Caribbean	6345	upward	Europe and Central Asia	1912	upward
Brazil	3955	upward	Poland	703	upward
Peru	1611	upward	Turkey	463	upward
Mexico	520	upward	Bulgaria	400	upward
Argentina	210	upward	Hungary	149	upward
Colombia	60	upward	Russian Federation	119	upward
Panama	20	downward	Czech Republic	50	upward
Venezuela	7	upward	Other	28	upward
Other	-38	upward			

Source : Central banks, national stock and securities exchanges, Micropal, various market resources and World Bank staff estimates based on net asset value of stocks of investment funds adjusted for price movements in individual equity markets

Table 1.L FDI stocks and inflows to Africa, by sub region, 1980-1985

(Millions of US Dollars and Percentage)

Region/ Sub-Region	Flows 1980-1984 Value	Share	1985-1990 Value	Share	1991-1995 Value	Share	Stocks 1980 Value	Share	1985 Value	Share	1990 Value	Share	1995 Value	Share
North Africa (a)	415	30.1	1278	46.4	1584	41.7	4429	11.9	8988	23.7	16109	30.7	20557	30.3
Southern Africa (b)	255	18.5	5	…	71	1.9	23831	63.8	16423	43.4	16367	31.2	16524	24.4
Rest of Africa	711	51.4	1485	53.6	2138	56.4	9074	24.3	12481	32.9	20029	38.1	30714	45.3
Total Africa	1381	100	2768	100	3793	100	37334	100	37892	100	52505	100	67795	100

Source : UNCTAD estimates based on UNCTAD-DTCI, 1996 a
(a) Algeria, Egypt, Libyan Arab Jamahiriya, Morocco and Tunisia
(b) Botswana, Lesotho, Mozambique, Namibia, South Africa and Zimbabwe

1.47 While these developments are impressive, views about the dramatic increase in private capital flows have to be tempered with three observations:

- one-third of what are recorded as FDI 'inflows' are actually reinvested domestic currency profits in the countries in which they are generated;
- what is recorded as FDI often contains a fairly substantial *debt* component the actual size of which is unknown
- private flows have been highly concentrated in only a few countries. They have not yet benefited the majority of developing countries and have by-passed low-income countries in SSA where operating conditions for private agents remain unpropitious despite major changes in policy regimes.

1.48 As a recipient of such flows, sub-Saharan Africa (SSA) has fared much worse than other regions. It has the least developed financial systems but a surfeit of DFIs. Within SSA, however, the SADC region has fared comparatively well. The following facts are illuminating in that respect:

- 70% of net private capital flows between 1990-98 went to 10 countries whose financial markets had integrated rapidly with international markets. Twenty countries accounted for 95% of private capital flows.
- 140 developing countries accounted for less than 5% of total recorded private flows to the developing world. This degree of concentration is less dramatic when: (i) intra-family remittances, other private transfers and unrecorded private flows are taken into account; and (ii) private flows are scaled by GNP, or on a per capita basis.
- Sub-Saharan Africa's share of private flows to developing countries was less than 2.5% in 1997-98. Though this proportion is low, it has risen *fivefold* from less than 0.5% in 1990, indicating the potential that exists for SSA to attract more private FDI and FPI flows.
- By the same token, the dollar amounts of private flows to sub-Saharan Africa have risen from an annual average of less than US$100 million between 1990-93 to an average of over US$6 billion for 1997-98.
- The proportion of CBL in private flows to SSA is larger than in other developing regions. Africa is not receiving as much FDI or FPI as it needs.

- SSA's share in total FDI flows to developing countries has declined from 7-8% in 1986-90 to 3.7% in 1994 and 3.1% in 1997-98. FDI inflows to SSA rose from US$1.86 billion in 1993 to US$4.87 billion in 1998. FDI was concentrated mainly in the oil-exporting countries before 1994, but shifted dramatically to South Africa thereafter. FDI flows to SSA have grown much more slowly than similar flows to other developing regions, which have increased exponentially since 1990.

- In 1998 SSA received 3.1% of net FDI flows to all developing countries with this share fluctuating in the range of 1.8% to 3.7% between 1990-96. The share of SSA in attracting FDI was lower than that of any other region except South Asia.

- In 1997, SSA received 5% of net FPI flows to developing countries with a 2% share in purchases of debt instruments but an 8% share of equity purchases by portfolio investors. In 1998 SSA's share of portfolio equity flows fell to 2.8% of total portfolio equity flows to developing countries and was lower than that for any other region.

- Over 90% of FPI flows to SSA between 1995-98 went to *South Africa*. Foreign investors account for half the trading on South African exchanges. Portfolio flows to SSA declined from US$6.7 billion in 1995 to US$5.8 billion in 1998 with portfolio equity flows declining from US$1.4 billion to less than US$400 million).

- The remaining 10% of FPI in SSA was divided between *Ghana*, *Zimbabwe*, *Cote d'Ivoire*, *Nigeria* and *Mauritius*.

- In 1995-96, two SADC countries dominated international bond issues by SSA - *South Africa* and *Mauritius* (which issued its first international bond for US$150 million to finance infrastructure - the issue had a 5-year maturity and was priced at 0.9% above LIBOR. This bond issue could be seen as a substitute for development finance). In 1997-98 there were no international bond issues by SSA borrowers.

- SSA's *stock* of FDI in 1998 was crudely estimated at about US$55 billion compared to external debt of US$226 billion and total GNP of US$331 billion in 1998. Thus SSA's outstanding FDI stock was about 24% of its outstanding external debt and 16.6% of GDP. (However, if SADC countries are separated out, then these ratios for the rest of SSA change to 13% and 16% respectively).

- This compares to the respective ratios of 40% and 18% for Latin America and the Caribbean; 77% and 24% for East Asia and the Pacific; 6% and 2% for South Asia; 7% and 3% for Eastern Europe and Central Asia; and 30% and 10% for the Middle East and North Africa.

- The above comparisons suggest that SSA is 'over-leveraged' (i.e. too much debt and not enough equity) in terms of its foreign debt-to-equity ratio compared to the successful economies of Latin America, East Asia and MENA, but under-leveraged relative to the less successful economies of South Asia and Eastern Europe. Excluding SADC, the rest of SSA has a foreign debt-to-FDI ratio of 8:1

- However, the picture is different for SADC since a substantial amount of the FDI in SSA is concentrated in that sub-region. The stock of FDI in SADC amounted to 35% of its external debt and 13% of GDP; ratios more similar to Latin America than to the rest of SSA. The SADC foreign debt-to-FDI ratio is a much healthier 2:1, although this overall sub-regional ratio obscures more than it reveals given the concentration of FDI in South Africa.

1.49 The foregoing observations notwithstanding, it remains true that, at the present time, SSA remains over-dependent on official flows (especially grants and concessional assistance), although that is perhaps less true for SADC than for other sub-regions in Africa. For SSA as a whole, official flows accounted for 67% of net resource transfers in 1998; a proportion that has fallen significantly from over 98% in 1990. These trends suggest that in Africa, and more so in SADC, the long-term outlook is for private flows to continue assuming increasing significance relative to official flows, although there may be short-term reversals in this process (as indeed there was between 1996-98). Donor aid budgets are becoming more constrained with a combination of budgetary restraint and aid fatigue, particularly in Africa. At the same time geopolitical considerations will require donors to spread their shrinking aid resources to areas other than SSA.

1.50 Early in the new millennium it is likely that private flows may exceed official flows in SADC; especially as incipient privatisation programmes (e.g. Mozambique and Zambia) accelerate. Private flows (from domestic and foreign sources) to privatised enterprises, mining firms and large industrial conglomerates, will offer a wider range of financing possibilities for investment in SADC - particularly in industry and infrastructure - than is apparent at present. The growth of FDI and FPI to SADC (and the developing world at large) was reversed between 1997-98. But the growth of such flows between 1990-96, and the turnaround that seems to be occurring again in 1999 as the financial crises of 1997-98 recede in importance, suggest that continued long-term growth of private capital inflows may moderate substantially the need that is perceived for development finance in SADC. This is even more likely to be the case if SADC governments move further and faster with policy reform and privatisation.

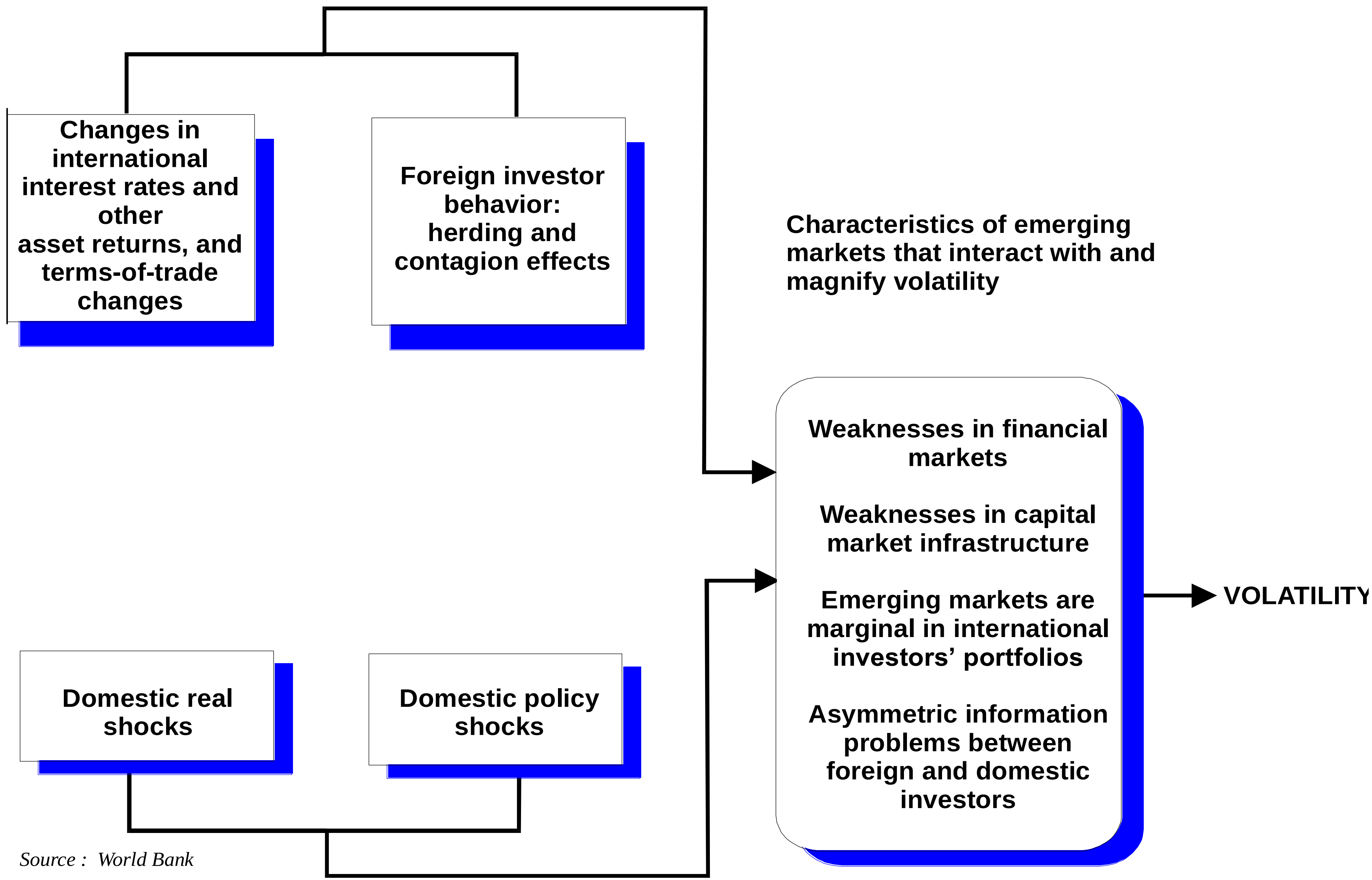
Public Finance Constraints: Withdrawal of Government from Financing Infrastructure

1.51 The domain of development finance is also being influenced by changes in the global consensus on:

- narrowing the definition and range of *public goods* and services;
- delineating services that needed to be financed through government budgets (e.g. governance, security, defence etc.) from those which can be provided on a commercial basis (e.g. utilities);
- asserting tight control over public finances with the reduction of public expenditures and re-orientation of expenditure priorities; and
- encouraging the state to withdraw from ownership of utilities and commercial enterprises.

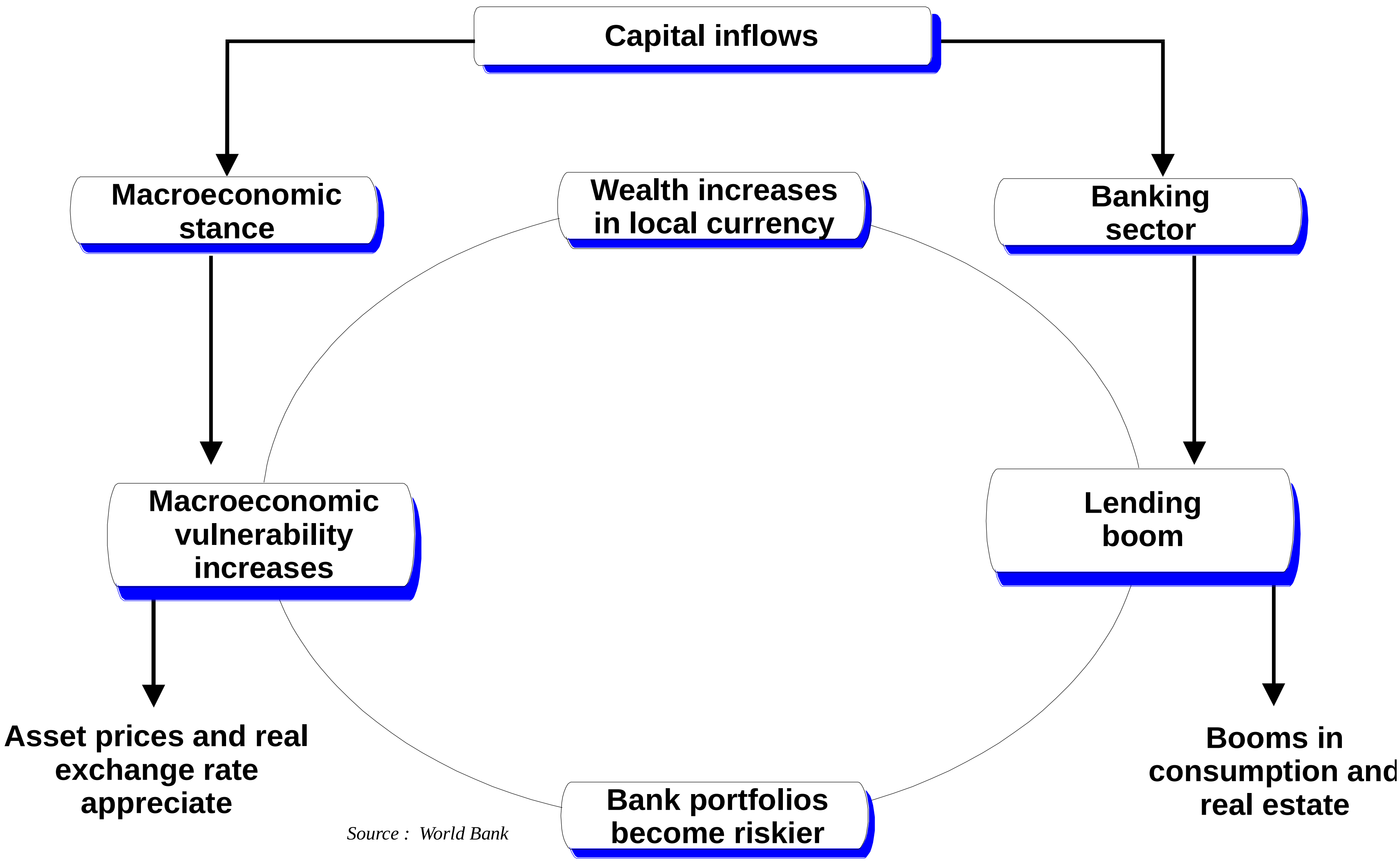
1.52 Emphasis on the last of these has been brought about indirectly by pressures exerted on governments by their external creditors since 1982 to give higher priority to repaying their debts. Those priorities resulted in efforts to divest loss-making public enterprises that were draining public budgets annually and to deploy the proceeds of such divestitures to retire external liabilities.

Fig 1.F Sources of volatility for foreign capital flows in emerging markets



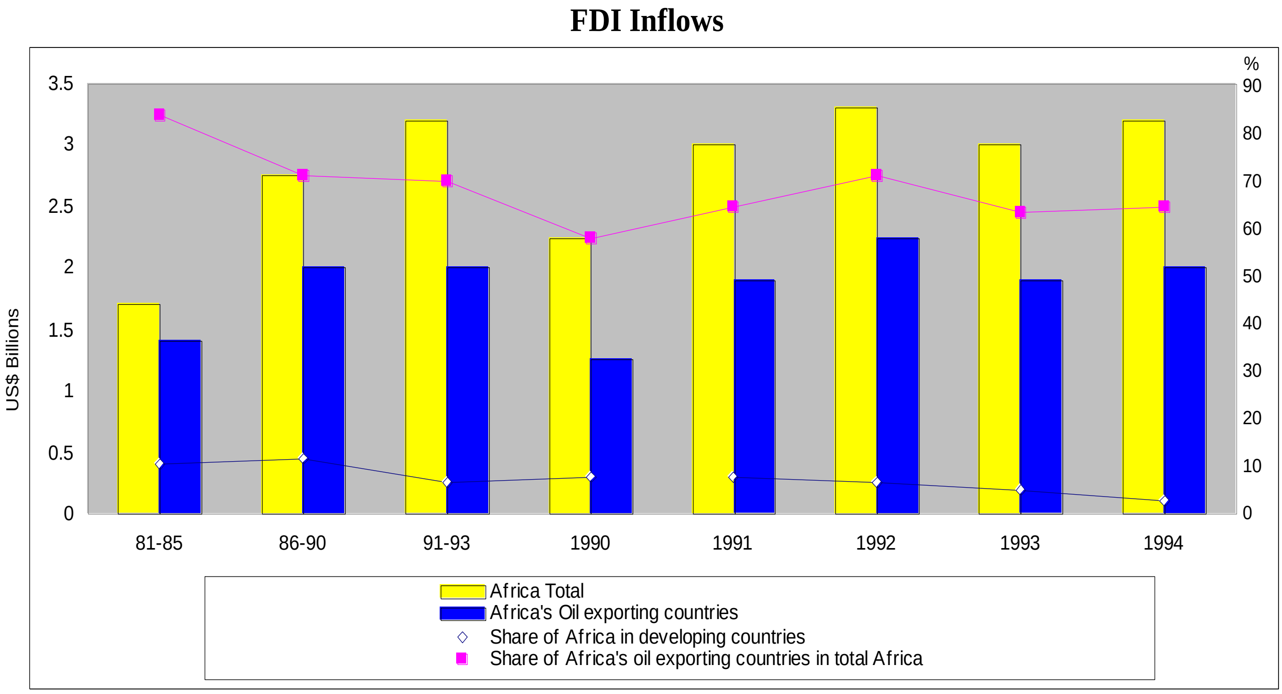
Source : World Bank

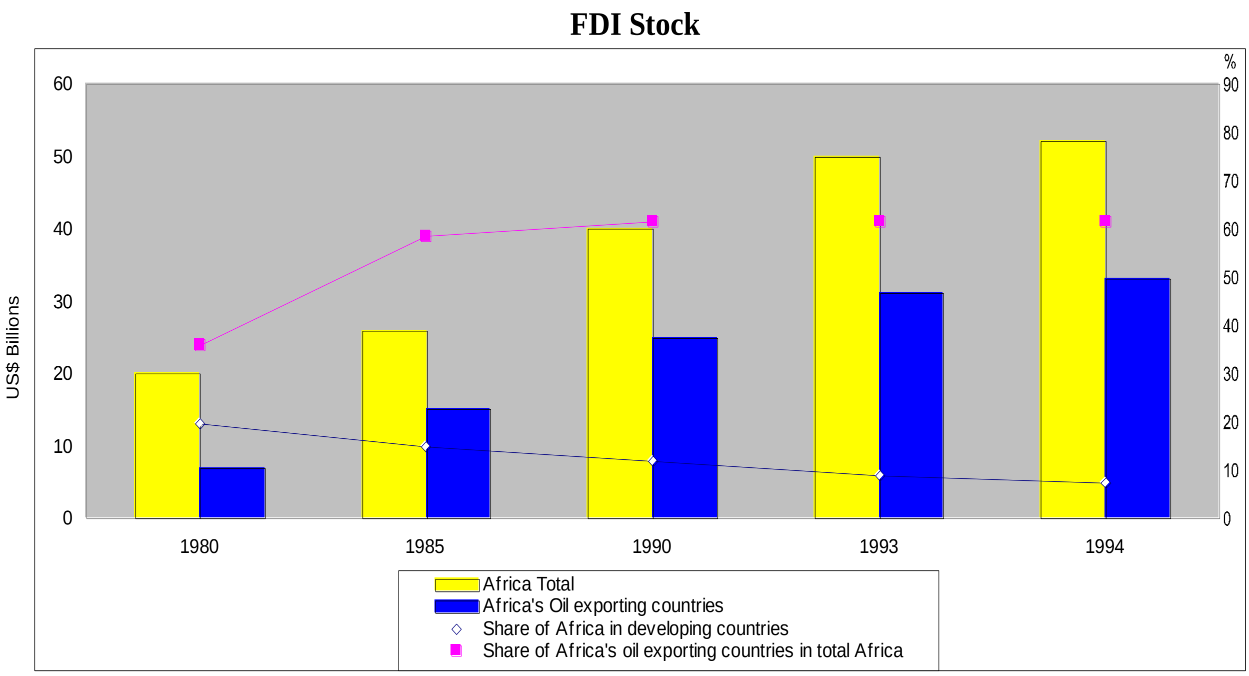
Fig 1.G Capital flows, lending booms and potential vulnerability



Source : World Bank

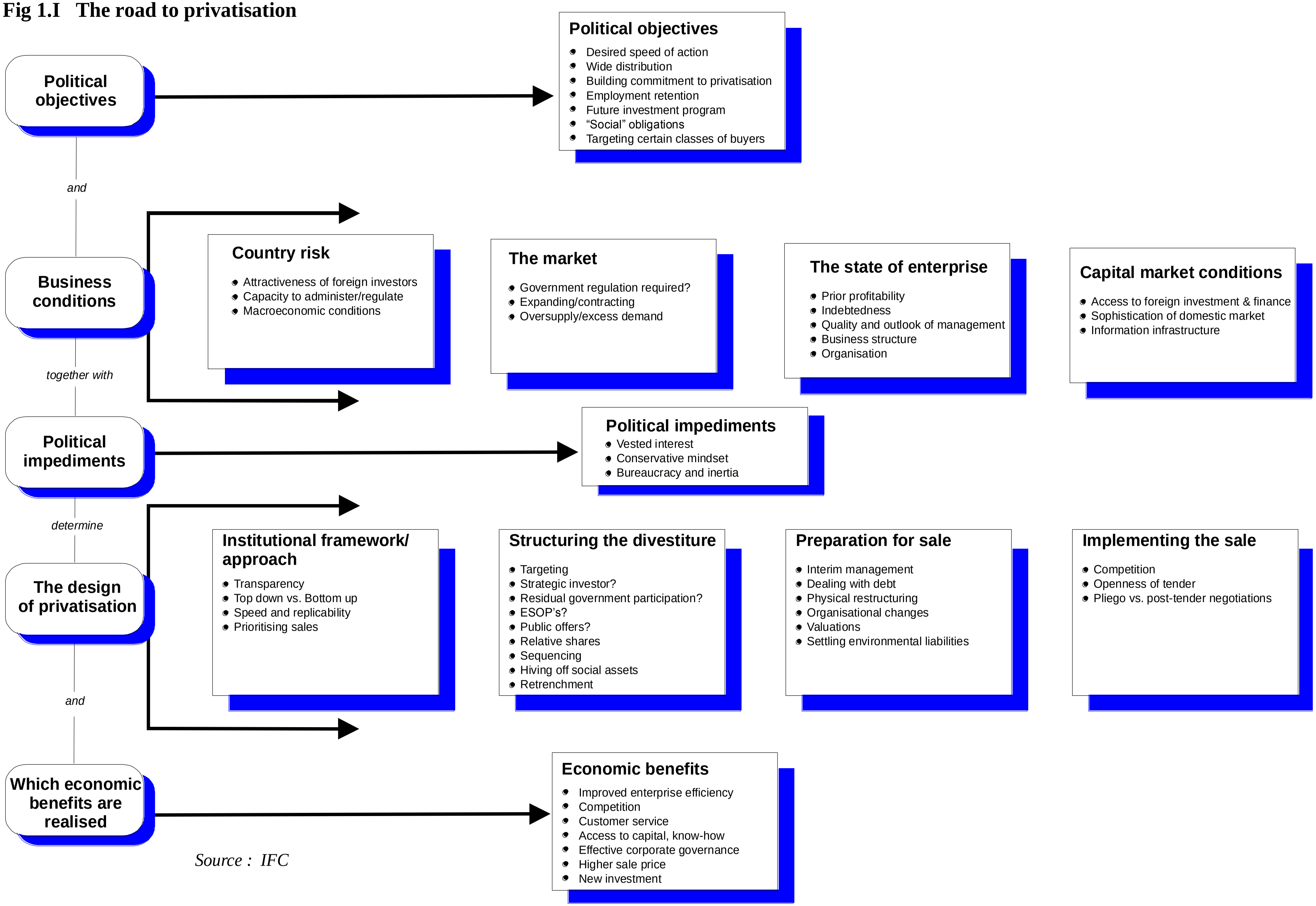
Fig 1.H FDI inflows and stock in Africa, 1980-1994





Source: UNCTAD, OECD

Fig 1.I The road to privatisation



Source : IFC

1.53 ***Financing Infrastructure - a brief historical digression****:* In evaluating past experience, understanding present possibilities, and contemplating the future, it is useful to digress briefly into how infrastructure was traditionally financed and why the paradigm is changing. In the 1960s and 1970s, there was a consensus (especially in the developing world) on the need for state intervention/ownership to rectify large economic distortions left in the wake of colonialism. Such distortions were evident in concentrations of wealth, patterns of asset ownership, the structure of goods and factor markets, as well as in other imbalances. They were reflected, for example, in imbalanced infrastructure investments and endowments, and in inadequate health and education systems.

1.54 Colonial administrations had made no investments in developing Africa's human capital. The orientation of agricultural marketing systems favoured cash crops rather than food production. And colonisation had imposed and embedded inherently unfavourable urban-rural terms-of-trade. Together, these realities guaranteed that the development prospects of newly independent African nations would be compromised if there were to be no departure from colonial legacies. In keeping with the socialist ethos of the times, there was broad consensus that new industrial enterprises and utilities would need to be state-owned and financed. Private ownership would make it difficult to manage the cross-subsidies involved (in welfare states) in providing public goods to low-income households and achieving better income distribution. Thus the theoretical benefits of public enterprise ownership seemed seductive while the potential costs were not apparent.

1.55 At independence, Africa had no indigenous private sector or entrepreneurial capacity to make the required large investments for modernising and industrialising the economies that had been structured to extract mineral resources or cash crops. African states were, therefore, encouraged by donors and MDBs to develop their economies on welfare-state principles in vogue throughout Europe at the time. That proved, in retrospect, to be an unaffordable choice. State-controlled command and siege economies proliferated in every sub-region of Africa as a consequence. Bipolar ideological confrontation (as well as opposition to apartheid) and competition between the West and East for the political soul and alignment of Africa between 1960-90 aggravated the damage it caused, bequeathing SSA with a legacy of dissipation - of human capital and infrastructure.

1.56 The onslaught of the debt crisis (which much of SSA remains trapped in even now), following 25 years of experience with state-controlled economies, made their costs and consequences too evident to ignore. Several unduly optimistic assumptions had been made when African countries became independent. These included assumptions about the: (i) capacity of states to undertake a wide range of business functions and govern well at the same time; (ii) quality and motivation of political leaderships in Africa; (iii) transparency and accountability of civil services; and (iii) ability of primary-commodity exporting economies to weather frequent exogenous shocks and natural disasters. In the event all these assumptions proved to be over-optimistic. Incapable states - further debilitated by the private agenda of public officials determining their economic and political behaviour - exacerbated economic failure throughout Africa on an endemic scale with unfortunate social and political repercussions.

1.57 As a result of the belated effects of adjustment initiatives triggered by the debt crisis, gradual political maturation in coming to terms with reality, and the demise of the cold war and apartheid, SADC (and SSA as well) is now in the process of repair and recovery. Two urgent priorities are to assert and maintain control over public expenditure and downsize (or 'right-size') the role of the state to focusing only on those functions it can perform competently. Exercising those priorities and managing public expenditure will clearly affect the need for development finance in SADC and SSA.

1.58 In one sense, constraints on financing capital investment through the fiscus *increases* the need for development finance to take up the slack. In another, the privatisation of public enterprises (dealt with in the next section) opens up new funding possibilities for banks and financial markets that, on balance, may *reduce* the need for development finance. But that can only happen *providing that all the risks involved in such investments can be borne by commercial players*. This last caveat is critical. It establishes a case for continued reliance on development finance in SADC until financial systems and markets have developed and globalised sufficiently to enable commercial financial agents to internalise those risks in their entirety. This section and the next dwell therefore on the issues raised by: (i) the needs for financing infrastructure investment; and (ii) privatisation. These are dealt with separately although they are obviously linked.

1.59 ***Infrastructure financing*** needs to be treated specially for five reasons.

- Such investments are crucial determinants of future growth in SADC. There is an established positive correlation between stock of infrastructure and economic growth. Studies across a wide range of countries show that a 1% increase in the stock of infrastructure, properly invested, leads to a 1% increase in the growth rate.

- Infrastructure investment is likely to be the most severely affected by public expenditure reductions - for maintenance and new capital investment purposes.

- Infrastructure projects involve long-gestating projects with complex financial engineering requirements, entailing the highest commercial and technical risks.

- Given their dependence on features of geography, topography, the availability of natural resources and the location of population concentrations, infrastructure investments, by their very nature, are most likely to be *sub-regional* in nature in any contiguous group of countries.

- They are the most likely to require *development finance* inputs in SADC - even after private commercial financing has been attracted - because the risks involved appear too large at the present time for the private sector to bear alone; especially in the less creditworthy countries of the sub-region.

1.60 Since 1985, the way in which infrastructure is financed around the world has undergone a significant change. Private capital has, once again, begun to dominate the financing of such investments, whereas between 1945-85 private finance for infrastructure was conspicuous by its absence almost everywhere other than the US. In one sense, the world has come full circle. Prior to 1945, most infrastructure investment was financed by private capital, but not always in exemplary fashion. There were successive financial crises (usually linked to the failure of private railway companies) caused by defaults on bonds by railroad companies in the Americas between 1860-1930. Anxiety to avoid repetition of that experience (and the mistakes of 1919-29, which sowed the seeds for the second world war) resulted in a massive programme of post-war infrastructure reconstruction being launched between 1945-60 on Keynesian principles, financed by the fiscus.

1.61 The breadth and scope of such a programme in the immediate post-war period was well beyond the capacity (and proclivity) of global private markets to finance without government intermediation and guarantees. Indeed the only viable and liquid financial market at the time was in the US. But the issue was not just that global private financing capacity was limited. Public financing of infrastructure was also justified on the grounds that access to electricity, potable water, fuel for heating (whether gas, oil or coal), and connections to sewerage mains were essential *public goods* (and indeed basic household rights) in a Europe moved by the ethos of welfare economics.

1.62 Following from the reconstruction experience in Europe and Japan (financed by the Marshall and Douglas Plans with insignificant participation by IBRD), as well as the Soviet economy's record in building infrastructure, it was not surprising that most infrastructure investments in the developing world between 1950-85 were undertaken by the public sector. Public finance was augmented by *development finance* provided by the global and regional MDBs. In the process these institutions accumulated the largest amount of technical expertise in organising and financing infrastructure investments. But, though MDBs (and some of the larger national DFIs) intermediated funds for infrastructure projects, the full extent of the financial and operating risks involved were invariably borne by governments. As experience unfolded, however, it became apparent that in most countries that subsidised utility and transport services, these risks proved too great for the fiscus to bear indefinitely. Consequently, infrastructure was poorly maintained, a considerable amount of installed infrastructure (especially in Africa) was lost.[1] and essential new investments (e.g. integrated power transmission grids and transport links) became impossible to finance.

1.63 This situation was characteristic not just of developing countries. Strains also appeared in the budgets of developed country governments pursuing the same paths. Led by the UK in 1980, a wave of privatisations occurred of public utilities (with shares being off-loaded in global capital markets), as well as industrial, transportation and telecommunications companies. That wave subsequently spread over the globe. As a consequence, MDBs and DFIs retrenched from being the principal financiers of infrastructure into becoming *niche* underwriters of specific risks (e.g. policy risks, exchange risks, term transformation risks and performance risks), which private institutions and markets remain reluctant to absorb. The need for such risks to be shared initially by public or quasi-public bodies (in the construction and pre-operating phases), but perhaps off-loaded eventually (following commercial operation), became apparent with the financing of the US$10 billion Eurotunnel project linking the UK with France. The initial enthusiasm of shareholders and merchant banks in financing that project has since been dampened with the large losses incurred by Eurotunnel in its early years - mainly because its capitalised financing costs were higher in the pre-operating phases of the project than what its financing structure could bear.

1.64 Infrastructure investment in developing countries is now estimated at about US$220 billion per year absorbing about 4% of its aggregate GDP (closer to 7% in East Asia) and about 20% of total investment (30% in East Asia). SSA, however, accounts for under 5% of the global total (<US$10 billion annually) with the result that indicators of infrastructure facilities available per capita in SSA are the lowest in the developing world. Infrastructure in most of SADC (especially in SACU and Zimbabwe) is better developed than in the rest of SSA. In Angola and Mozambique, basic infrastructure has been ravaged by the legacy of conflict. Its reconstruction offers SADC with a financing challenge as well as an opportunity for employment generation and growth over the next decade. In Malawi, Tanzania and Zimbabwe constraints on public finance, coupled with a reluctance to proceed with privatisation as rapidly as in other SADC countries (e.g. Zambia) have caused infrastructure to deteriorate rapidly. There has been a consequent loss of usable capacity, especially in their road networks. While the private sector is unlikely to invest in roads per se, its willingness to invest in electric power, telecommunications, ports, airports and airlines, would release sufficient public resources to finance the rehabilitation of roads and railways.

[1] For example, in 1994 the World Bank (WDR, 1994) estimated that timely maintenance expenditures of US$12 billion would have saved road reconstruction costs of US$45 billion in SSA in the 1985-94 period.

Box 1.C: Infrastructure in SADC Countries						
	Percentage of population with access to			***Paved roads as % of total roads***	***Railways***	***Telephone lines***
Country	***Electricity*** ***1995 (%)***	***Water*** ***1993-95 (%)***	***Sanitation*** ***1993-95 (%)***	***1990 (%)***	***1993-97 Route km***	***1993 per 100 population***
Angola	**9**	**32**	**16**	**12**	**2648**	**0.51**
Botswana	**15**	**70**	**55**	**14**	**888**	**3.10**
Lesotho	**3**	**57**	**35**	**8**	**2**	**0.56**
Malawi	**5**	**54**	**63**	**18**	**789**	**0.35**
Mauritius	**na**	**100**	**100**	**91**	**0**	**19.62**
Mozambique	**5**	**28**	**23**	**17**	**3131**	**0.37**
Namibia	**12**	**57**	**36**	**8**	**2382**	**4.46**
South Africa	**55**	**77**	**46**	**31**	**20319**	**9.00**
Swaziland	**14**	**na**	**na**	**18**	**301**	**1.80**
Tanzania	**6**	**49**	**86**	**4**	**4400**	**0.32**
Zambia	**11**	**47**	**42**	**18**	**1273**	**0.91**
Zimbabwe	**16**	**74**	**58**	**19**	**2759**	**1.20**

1.65 Private financing from global capital markets for infrastructure investment in developing countries accounted for less than 1% of total investment in 1985 (US$1.35 billion) and under 2% in 1990 (US$2.64 billion). Its share has grown rapidly since to 7% in 1993 (US$ 18 billion), 10% in 1995 (US$22.3 billion) and 13% in 1998. The trend for continuing growth in this share appears to be established, especially with the increasing privatisation of utilities around the developing world. Total privatisation proceeds from sales of state-owned infrastructure companies increased from USUS$9.7 billion in 1990 to US$37.4 billion in 1997. Development finance from the MDBs and competitive packages of commercial-cum-export finance from bilateral sources in the OECD countries accounts for between 12-15% of infrastructure investment in developing countries. Public finance from government budgets accounts for most of the remaining 75-78%.

1.66 Resources raised from *domestic* capital markets in developing countries - including funds raised by national DFIs as well as by governments through public bond issues in local currency - accounts for a relatively small share of infrastructure financing. At present that share is estimated at less than 5% although accurate statistics on this are not collected as a matter of course and good figures are hard to come by. But, if the 1994-97 experience of India and countries in Southeast Asia is a reliable guide, such shares are likely to climb rapidly in Asia (from less than 5% to more than 20% by 2005) in replacing sources of tax-generated public finance. Given the relatively developed states of capital markets in SADC, it would not be unrealistic to aim at achieving a share of 20-25% for infrastructure financing in the region from domestic capital markets over the next decade.

1.67 Within the totals of private financing raised from global capital markets for infrastructure investment in developing countries, SSA absorbs a negligible amount - under 2% of the total in 1995 (less than US$400 million) of which about half is accounted for by SADC. This very low proportion reflects how far SSA lags behind other developing regions in privatising (and raising private funds for) its utilities and creating operating conditions conducive to private investment in key infrastructure sectors. The SADC sub-region offers special opportunities to attract much larger amounts of infrastructure financing from global markets quicker than the rest of SSA. That is because of its relatively advanced level of physical infrastructure which makes it more 'privatisable'. Also, the notion of privatisation has taken hold more firmly in SADC than in other parts of SSA, and its financial markets are more developed and more integrated with global markets. The over-subscribed international bond issue by Mauritius in 1995 showed that there is considerable potential for SADC members to tap international markets (for both debt as well as equity capital) for investment in infrastructure *before* considering a large-scale expansion of the development finance option. But the two are not mutually exclusive in the sense that DFIs can be useful conduits in tapping such markets.

1.68 If SADC's member governments are to raise greater amounts of private financing for infrastructure, they need to address a few key policy issues urgently. These concern:

- accelerating the privatisation of commercial infrastructure assets;
- inducing greater competition in electricity, telecommunications and transportation;
- insisting on full cost recovery with a regulated margin for profit; and
- targeting subsidies carefully to support demand only on the part of low-income households rather than providing cross-subsidies to high-income groups through controlling the supply side to provide services at prices that are lower than costs.

1.69 Such policies will require the commensurate build-up of adequate regulatory capacity in each infrastructure sector to ensure that the interests of monopoly (or oligopoly) service-providers, and those of consumers, are accommodated in a balanced fashion. *Relying on development finance to fund regional infrastructure projects before SADC countries address these policy issues would be a second-best, soft-option. In the long run it might prove more expensive and wasteful of scarce public resources.* It might also result in inefficient patterns of investment which would capture neither the opportunities that an enlarged regional market affords, nor the economies of scale which the alternative option (i.e. that of preceding with privatisation and policy change) allows (AfDB:1993).

1.70 Would a *sub-regional DFI* in SADC be able to mobilise resources from international, regional and domestic capital markets more efficiently and in greater quantities than the network of DFIs and other financial institutions which already exists in SADC? Would a sub-regional DFI be more effective than the present network of national DFIs in persuading SADC governments to make the policy changes necessary to capture the benefits of expanded private financing? These questions are explored later.

1.71 Though this section has intended to indicate that new options are emerging for financing infrastructure, it has not intended to suggest that all of SADC's infrastructural needs can be financed through private capital. In the medium-term (the next 5-7 years) it would be surprising if private capital increased its share of such financing in SADC from its present level of under 5% to much more than 20% and certainly no more than 30%; even under the most propitious circumstances. For the foreseeable future, private capital is likely to be interested mainly in electric power, telecommunications, pipelines and the airline sectors and in the middle-income, creditworthy countries of the sub-region. There may also be some private interest in running ports and airports as well. Infrastructure involving roads and water supply offer less attractive opportunities in SADC at the present time. *That still leaves a very large amount of such investment to be financed from government budgets (public finance) and through development finance organised along efficient lines, and available flexibly across the sub-region, rather than development finance confined to national envelopes.* This will be particularly the case in sectors where private risk-bearing capacity and command over the cash flows emanating from such investments is limited.

The Impact of Privatisation on the Need for Development Finance in SADC

1.72 Private capital flows, private financing for infrastructure and constraints on public finance, along with privatisation itself, are inter-related phenomena. They are discussed separately in the sections of this chapter because each has different aspects, dimensions and characteristics. Each poses distinct issues and challenges for governments and DFIs. As with the first three of these considerations, discussed in the preceding sections, growing ***privatisation*** in SADC - as it catches up with what has been happening in the rest of the world - will have an impact on the demand for development finance in the sub-region. After privatisation, most parastatal enterprises will depend less on financing from DFIs and state-owned commercial banks. They will rely more on private commercial sources of financing from domestic and foreign capital markets for equity and debt.

1.73 That trend is discernible with those enterprises in the sub-region that have already been privatised (e.g. breweries, mining companies, hotels, etc.). It will accelerate in the coming years. In Zambia, for example, the Development Bank of Zambia's operations have been substantially reduced at the same time that privatisation is taking off - suggesting clearly the virtual independence of the privatisation process from the need for development finance at the national level. However, it has to be acknowledged that the privatisation process in Zambia would not have reached this stage, indeed may not even have begun, if it were not for the intervention and support of DFIs at the regional and global levels.

1.74 Annual proceeds from privatisation in the developing world grew from US$2.6 billion in 1988 to a peak of almost US$66.7 billion in 1997. Over that period, the aggregate proceeds from privatisation amounted to over US$222 billion, which was just over 9% of the total outstanding external debt of all developing countries. Expectedly, the largest amount of privatisation (US$116.5 billion) occurred in Latin America, accounting for 51% the proceeds derived in the developing world as a whole. By comparison, East Asia, (US$37.5 billion) and Eastern Europe (US$47.1 billion) account for about 17% and 21% respectively of the total. These three regions therefore accounted for 89% of the privatisation proceeds realised by developing countries up to now. South Asia (US$9.8 billion) accounted for a further 4.5% while the remaining 6.5% was divided between MENA (US$5.1 billion) and SSA (US$6.2 billion).

1.75 Foreign resources attracted by privatisation transactions in all developing countries between 1990-97 amounted to nearly US$98.6 billion - or 44.4% of the total proceeds raised. Of the foreign funds involved, US$64.4 billion was in the form of FDI and a further US$34.2 billion was FPI (equity and debt). In SSA however, the foreign component of privatisation proceeds was 59% - higher than the average for all developing countries.

1.76 Receipts from privatisation in any given country or region can be expected to show a bell-curve pattern. Receipts reach a peak 4-5 years after the take-off of a privatisation programme and taper off downwards over the next few years as the stock of public assets available for divestiture gets depleted. For the developing world as a whole, the overall level of annual receipts from privatisation is expected to average US$50-60 billion over next decade. Regions that have been slow to privatise thus far (i.e. South Asia, MENA and SSA) will begin to advance their programmes at the same time that privatisation proceeds in regions with more advanced privatisation programmes begin to wane.

1.77 The bulk of developing country privatisation proceeds (over US$102 billion or 45%) between 1990-97 was from the privatisation of infrastructure. Of that amount US$82 billion (or 37% of the total) was derived from the sale of telecommunications and electric power companies. A further 20% (US$45 billion) was derived from industrial and construction companies while 15% (US$33 billion) was from petroleum and mining companies, another 12% (US$26 billion) from banks and financial institutions, with the remaining 8% accruing from companies providing other services (mainly transport operations, hotels and tourism).

1.78 The SSA share of 2.8% of total developing world receipts from privatisation indicates that there is considerable room for Africa as a whole, and for SADC in particular, to derive substantially larger proceeds from international (and domestic) capital markets in the future with the divestiture of public enterprises. Privatisation proceeds in Africa have fluctuated from a low of US$74 million in 1990 to US$1.2 billion in 1991 and averaged about US$500 million annually between 1992-96 before rocketing to US$2.35 billion in 1997. That apart, if experience from other countries is a guide, privatisation in SSA and SADC is likely to engender improvements in operating efficiency and multi-factor productivity, as well as in tax revenue-generating capacity in the industrial and infrastructure sectors.

1.79 Ten countries in SSA - Nigeria, Kenya, Tanzania South Africa, Ghana, Zambia, Zimbabwe, Uganda, Mozambique and Côte d'Ivoire - accounted for 93.5% of the region's total privatisation receipts between 1990-97. Five of these are SADC countries; and they accounted for 54% of SSA's total. In areas such as infrastructure, the privatisation of assets in SSA and SADC has barely begun; but the signs are encouraging. In 1994 the World Bank reported just two privatisation transactions in SADC (both in Zimbabwe) which yielded a total of US$231.5 million. In 1995 that number had increased to 58 in five SADC countries (Malawi, Mozambique, Tanzania, Zambia and Zimbabwe) with a total of US$255 million being realised. In 1997, the number increased again to 85 privatisations raising some US$3.3 billion, although 50% of the total proceeds from privatisation derived from the sale of shares in telecommunications companies alone.

1.80 The potential realisable proceeds from the full or partial sale of equity in publicly owned assets in SADC - in telecommunications, power, oil and gas, airlines, financial institutions, tourism, construction, ports and airports, not to mention heavy industrial (steel and cement), mining (ZCCM in Zambia is about to be privatised), construction and manufacturing companies - will probably run into tens of billions of dollars. Such privatisations would bring with them additional investments (financed from domestic and foreign sources) of an equal or larger amount as companies in these areas are restructured and their technology upgraded to become more regionally and globally competitive. At the same time, such privatisations would ease considerably the pressure on over-stretched public budgets and relieve constraints on expanding higher priority expenditures in education, health, low-cost housing, and employment generation programmes.

1.81 But there are reasons and limits as to why privatisation in SSA and SADC may not be proceeding at as fast a pace as might be desirable. These include:

- insufficient absorptive capacity for privatisation in national, domestic capital markets in SSA and some SADC countries;
- conflict between the revenue-raising, market-development and efficiency objectives of privatisation programmes;
- absence of adequate regulatory capacity to ensure competition and force efficiency in the operations of post-privatised utilities and companies;
- insufficient domestic capacity for asset valuation in countries where land and asset markets are unformed or highly imperfect;
- insufficient local knowledge of privatisation techniques and issues engendering the suspicion (and possibility) that privatisation would result in the sale of national assets at excessively low prices;
- possible emergence of private monopolies and conglomerates owned by influential local figures with access to insider information and privileged access to public enterprises (i.e. the entrenchment of crony capitalism);
- concern that privatisation will lead to retrenchment in public enterprises, leading to opposition from the civil service, enterprise managers, and organised labour;
- absence of budget capacity to provide for retrenchment safety nets;
- concern that new investments after restructuring will not yield equivalent employment opportunities;

- the risk that privatisation might lead to excessive concentration of strategic asset ownership among foreign investors resulting a new form of investor-driven colonialism; and
- political aversions to the entry of investors of particular ethnicity or nationality through the privatisation process.

Table 1.M Privatization revenues in East Asia and the Pacific, 1988-95

(Millions of US Dollars)

Country	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*Total*
China				11.0	1262.0	2849.0	2226.0	685.0	**7033.0**
Indonesia				190.0	13.9	31.1	1748.0	2031.0	**4014.0**
Malaysia	16.0	31.0	375.0	387.0	2383.0	2148.0	798.0	2519.0	**9158.0**
Philippines		80.0		244.0	754.0	1638.0	494.0	208.0	**3417.0**
Thailand	5.0	85.0		2.0	237.5	471.0	242.0		**1042.0**
Other			1.0	0.0	9.8	17.8		5.0	**33.0**
Total	**21.0**	**196.0**	**376.0**	**835.0**	**5161.0**	**7155.0**	**5507.0**	**5447.0**	**24698.0**

Table 1.N Privatization revenues in Latin America and the Caribbean, 1988-95

(Millions of US Dollars)

Country	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*Total*
Argentina	28		3841	1981	5567	4732	890	1208	**18247**
Bolivia					9	13		789	**810**
Brazil		8	44	1635	2564	2718	1697	992	**9658**
Chile	278	302	98	364	8	106	128	13	**1297**
Mexico	1915	971	3160	11289	6924	2132	766	167	**27324**
Peru				2	212	127	2840	1276	**4457**
Venezuela			10	2278	140	36	8	39	**2511**
Other	309	154	144	439	382	797	1490	140	**3855**
Total	**2530**	**1436**	**7297**	**17989**	**15797**	**10646**	**7818**	**4623**	**68136**

Table 1.O Privatization revenues in Europe and Central Asia, 1988-95

(Millions of US Dollars)

Country	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*Total*
Bulgaria						45	147	111	**302**
Czech Republic						645	7	1645	**2297**
Hungary		462	483	798	787	1754	420	3254	**7957**
Poland			62	338	240	733	641	980	**2994**
Russian Federation				35	88	110		1002	**1234**
Slovak Republic						63	415	1004	**1482**
Turkey	27	216	437	212	780	483	354	572	**3081**
Other		7	322	1400	2446	318	895	370	**5758**
Total	**27**	**685**	**1304**	**2783**	**4341**	**4151**	**2879**	**8937**	**25107**

Source : World Bank, GFR 1997

Table 1.P Privatization revenues in the Middle East and North Africa, 1988-95

(Millions of US Dollars)

Country	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*Total*
Egypt						328	179	173	**679**
Morocco						273	347	240	**860**
Tunisia	7	14	2	17	60			32	**133**
Other					9	26	42	212	**289**
Total	**7**	**14**	**2**	**17**	**70**	**627**	**567**	**657**	**1961**

Table 1.Q Privatization revenues in South Asia, 1988-95

(Millions of US Dollars)

Country	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*Total*
Bangladesh		1				43	12	5	**61**
India				931	1098	861	1505	52	**4447**
Pakistan			11	63	343	17	1106	36	**1577**
Sri Lanka		3	18	2	106	52	42	65	**288**
Other					11	1	1		**13**
Total		**3**	**29**	**996**	**1557**	**974**	**2666**	**159**	**6384**

Table 1.R Privatization revenues in Sub-Saharan Africa, 1988-95

(Millions of US Dollars)

Country	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*Total*
Cote d'Ivoire				10	6	5	14	120	**154**
Ghana		1	10	3	15	28	476	87	**619**
Mozambique		1	4	5	9	6	2	26	**52**
Nigeria		33	16	35	114	541	24		**764**
South Africa		632		5					**637**
Uganda					12	19	24	47	**101**
Zambia								69	**69**
Zimbabwe							232	75	**307**
Other	10	16	44	2	35	49	22	121	**299**
Total	**10**	**683**	**74**	**60**	**191**	**648**	**792**	**544**	**3002**

Source : World Bank, GFR 1997

1.82 Many of these limitations are real and binding. Others are more the outcome of political prejudices and mistaken perceptions. The real impediment, as the case of Zambia has proven after seven years of vacillation over privatisation, is the political commitment and the administrative will to take the first step. Once that step is taken, experience in SADC, other SSA countries and the rest of the developing world suggests that the remaining obstacles can usually be dealt with in one way or another.

1.83 Relying on a new regional source of development finance as an option to delay taking these steps and prolong the life of public enterprises is likely to be a backward-looking option with counterproductive consequences in the short and medium-term. Clearly, in environments where capital markets remain relatively undeveloped, there may be a unique interim role for national DFIs in SADC to play in accelerating rather than retarding the process of privatisation by tackling some of the impediments that thwart its smooth progression. In this respect national DFIs could operate in tandem with the global and regional MDBs. *But this must be seen as an interim task. In the long run, successful privatisation (particularly of large enterprises and infrastructure companies) should induce substantially reduced reliance on development finance in SADC as these enterprises come to depend more on commercial sources of finance in competitive capital markets.*

(Millions of US Dollars)

Sector	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*Total*
Infrastructure	798	693	6005	6796	9810	4245	9381	9351	**47079**
Telecommunications	325	212	3690	5821	3007	1083	6069	4543	**24744**
Energy	106	8	59	364	4901	1897	2176	4526	**14033**
Industry	52	791	1118	5400	7508	7171	5254	3963	**31258**
Steel	0	97	197	2282	2025	2917	1209	274	**9002**
Chemicals	0	5	3	617	964	749	1125	614	**4077**
Construction	7	224	196	485	1379	523	689	641	**4145**
Other manufacturing	45	465	721	2017	3140	2982	2231	2434	**14035**
Primary sector	1374	225	1588	1728	3421	6582	4061	5356	**24335**
Petroleum	0	9	567	1226	2357	5065	1981	3775	**14979**
Mining	1360	50	485	236	548	187	1411	618	**4896**
Financial services	8	241	47	7810	5259	3514	971	1891	**19740**
Banking	8	175	47	7522	5099	2608	734	1113	**17306**
Other services	362	1068	256	924	763	2688	561	555	**7176**
Total	**2594**	**3017**	**9013**	**22659**	**26761**	**24200**	**20228**	**21116**	**129588**

Table 1.T Foreign exchange raised through privatization in developing countries 1988-96

(Millions of US Dollars)

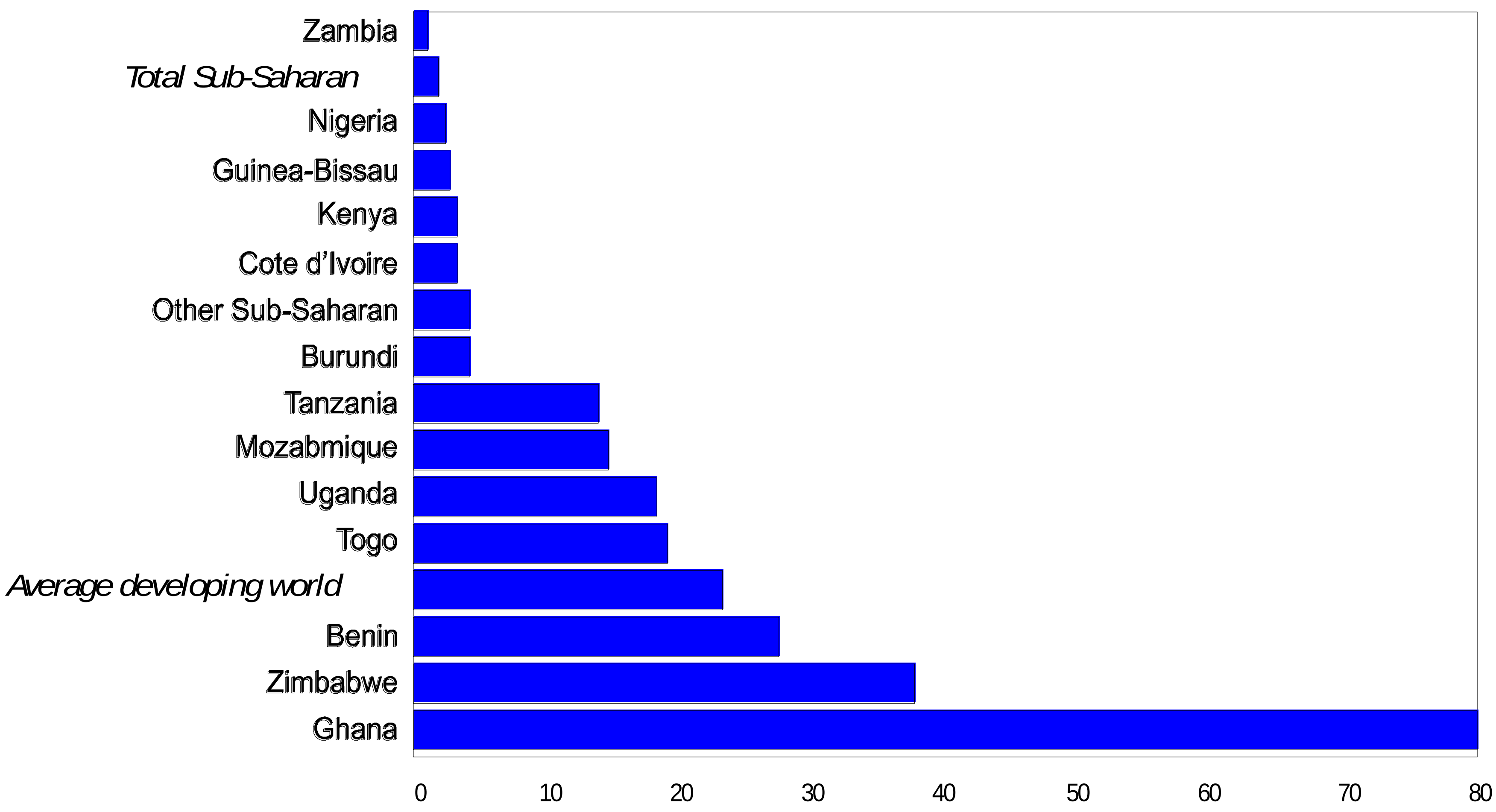
Region	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*Total*
East Asia	1	0	1	102	1556	4156	4036	2062	11913	**11913**
Europe and Central Asia	14	666	628	2107	3724	3033	1460	6059	17691	**17691**
Latin America and the Caribbean	353	323	2565	7093	3827	3719	5632	2106	25617	**25617**
Middle East and North Africa	0	1	0	3	19	299	158	16	497	**497**
South Asia	0	0	11	4	44	16	997	38	1110	**1110**
Sub-Saharan Africa	0	14	38	11	61	573	663	269	1630	**1630**
All Developing Countries	**368**	**1004**	**3243**	**9321**	**9231**	**11797**	**12946**	**10549**	**58458**	**58458**

Table 1.U Portfolio Investment and Foreign direct investment in Privatization 1988-95

(Millions of US Dollars)

Type	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*Total*
Foreign direct investment	368	1004	3132	5778	6470	6711	6098	8076	**37636**
Portfolio investment	0	0	111	3542	2761	5086	6848	2473	**20822**
Total	**368**	**1004**	**3243**	**9321**	**9231**	**11797**	**12946**	**10549**	**58458**

Figure 1.J Privatisation revenues per $1,000 of GDP, 1988-1994
(US Dollars)



Source : World Bank / IFC

Chapter Conclusions

1.84 This chapter has established that *development finance* is no longer as clear cut a notion as it once was. Nor are DFIs - national or sub-regional - regarded as obvious solutions to financing investment requirements, as they once seemed to be. Development finance in SADC is a moving target. The demand for such finance, and the activities of institutions providing it is, and will continue to be, in a state of flux. Both will be determined by the shifting boundaries of *public finance* (which is shrinking) and *commercial finance* from evolving and fast-integrating capital markets (which is expanding).

1.85 The *demand for development finance* in SADC will depend heavily on:

- how rapidly governments in SADC withdraw from financing infrastructure through budget resources and what mechanisms they resort to in filling the void that leaves;

- steps the sub-region and its constituent members take to benefit from attracting a greater volume of private capital flows, which are now more significant than flows of official finance;

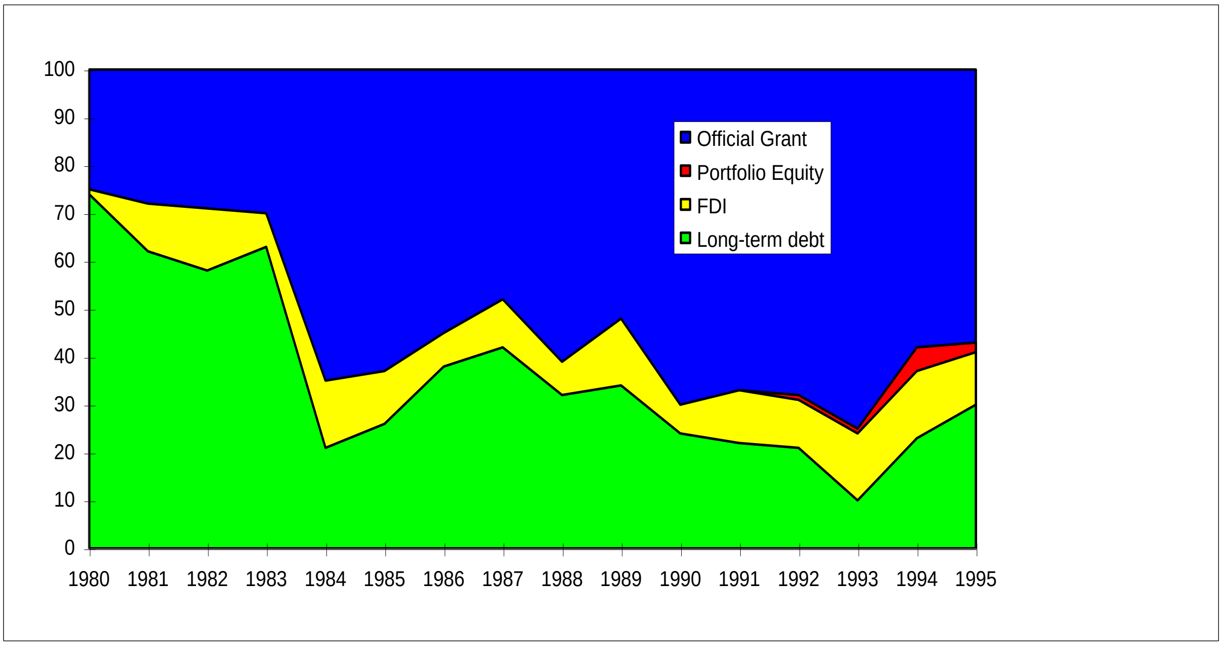
- the extent to which SADC governments begin to rely on domestic, regional and global capital markets for financing infrastructure and heavy industrial investment;

- the commitment of SADC governments to move ahead with their programmes of privatisation in order to derive the same benefits that countries in East Asia, Latin America, Eastern Europe, and to a lesser extent, South Asia are now reaping.

1.86 The lessons of historical and recent (post-1990) experience from Africa and elsewhere suggest strongly that resorting to development finance - whether through new regional mechanisms or existing DFIs - simply to postpone or delay timely action on these four frontiers is likely to prove damaging and counterproductive to the long-term interests of SADC and its members. The issue therefore is whether, in the face of shortcomings in domestic and regional capital markets, recourse to a greater amount of development finance in the short-run - and/or to the institutional capacity of a sub-regional mechanism to dispense it along with other non-financial services - can facilitate progress along these frontiers rather than retard it.

Figure 1.K Composition of Capital flows: Sub-Saharan Africa 1980-95

(In Percent)

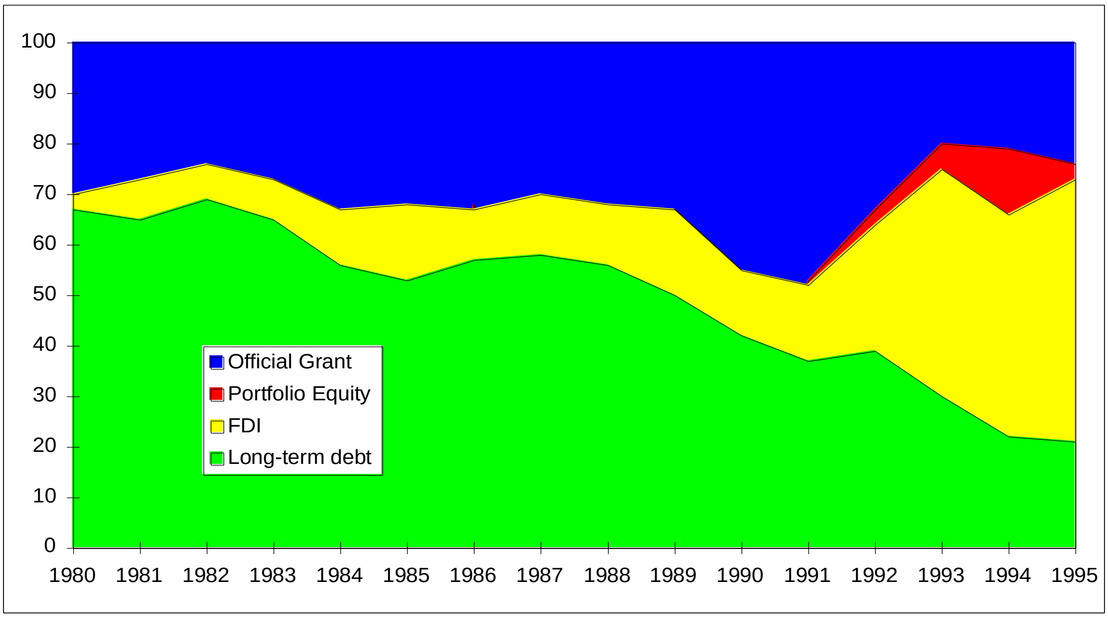


Source: The World Bank: World Debt Tables.

1995 figures are estimates

Figure 1.L Composition of Capital flows: Low Income Countries 1980-95

(In Percent)



Source: The World Bank: World Debt Tables.

1995 figures are estimates