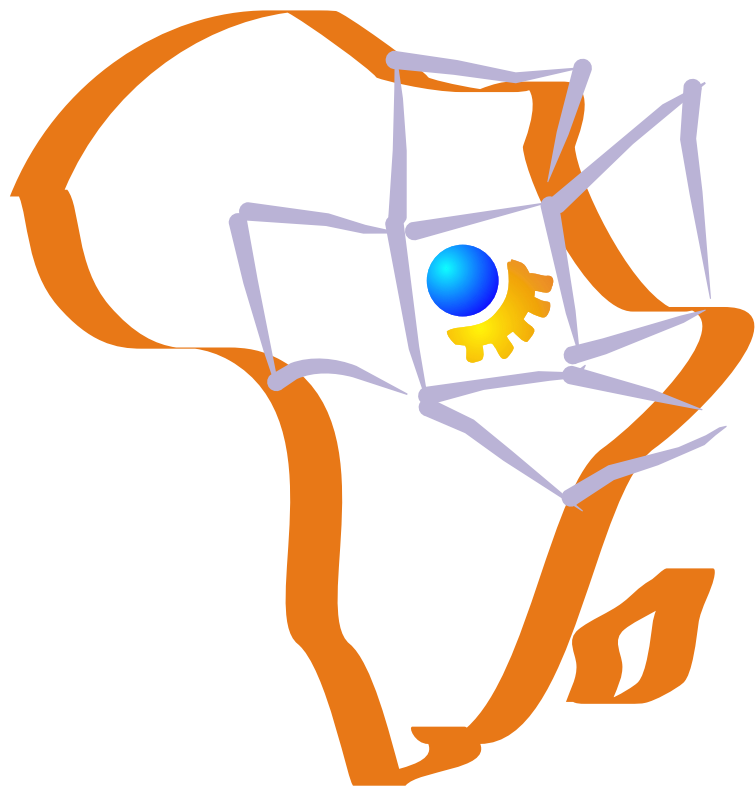


Background paper for the Conference



INTERNATIONAL CONFERENCE

New financing mechanisms for Africa's development

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The present paper has been realised by a research group composed by:

Directors

Umberto Triulzi, Professor at the University of Rome "La Sapienza" and Scientific Director of IPALMO

Marcella Corsi, Professor at the University of Rome "La Sapienza" and Fondazione Risorsa Donna

Researchers

Fabrizio Botti, Research Fellow at the University of Rome "LUISS Guido Carli"

Giovanni Canitano, Research Fellow at IPALMO

Giulia Zacchia, Research Assistant at the University of Rome "La Sapienza"

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1. Executive summary

The international agreement reached in September 2000 to meet the Millennium Development Goals (MDGs) has provoked a renaissance of political awareness about development problems in less developed countries, especially those of Sub-Saharan Africa (SSA). Indeed, the challenge that the international community faces in meeting the MDGs is substantial. According to the last available estimates, meeting the MDGs would cost about US\$ 50 billion yearly. In low-income countries, the financial gap amounts to US\$ 73 billion in 2006, rising to US\$ 135 billion in 2015 (UN Millennium Project, 2005), which means a nearly threefold increase in official development assistance (ODA).

In 2002 at Monterrey, donors pledged to provide additional US\$ 12 billion a year of extra funding by 2006. Indeed, ODA is steadily increasing, but still falls short of even conservative estimates of what needed to meet the MDGs by 2015. This amount has been labelled the "resource gap", and a rich debate has arisen around the financial mechanisms that could be put in place to close this gap. Given the current constraints on public budget in donor countries, it is expected that additional resources would originate especially from private sources.

However, private flows to developing countries are low and highly volatile. In SSA, the private sector has been even less keen to invest. This is especially true for commercial banks, which have reduced their exposition all over the 1990s. According to official data, a net increase of these resources is estimated to have occurred only in the year 2004 (World Bank, 2005). Traditional channels of private flow to developing countries, especially portfolio investment, have also proved to be very difficult to manage from the perspective of macroeconomic equilibrium. Hence, innovative means of involving the private sector in financing development initiatives must be carefully explored, with a view of devising financial packages that are appropriate to the targeted countries.

In addition to securing additional resources, it is equally important to ensure that resources deliver value for money. Therefore, further improvements in the effectiveness and greater concentration of development aid will be needed on those projects that yield the highest benefit in terms of overcoming domestic supply bottlenecks.

Finding the right instruments to target development finance is key to maximizing returns from foreign capital and avoid debt crises.

The present document is intended to stimulate the discussion around the possible ways to derive better results from joining the use of several sources and means of development financing. Two questions are addressed herein: how to deliver additional development finance to Sub-Saharan Africa in order to close the resource gap, and how to target financial assistance to key private initiatives in the productive sector that can generate employment creation and widespread increase in pre-capita income. In fact, despite recent good growth, Africa remains a desperately poor continent. Poverty and disease are widespread, and sub-Saharan Africa has the world's highest illiteracy. Incomes remain terribly low and conflict is also a threat. There is a growing sense that barring great effort, the Millennium Development Goals will simply not be reached by 2015.

As regards the sources of development finance, aid, debt relief, private commercial and private not-for-profit sources are discussed in the present document. As regards the means for promoting pro-poor growth and enhancing the effectiveness of foreign flows, an explicit choice in favour of tailored financial programmes has been made.

On the one hand, microfinance institutions should be further promoted, since they are recognised as a key source of poverty alleviation and pro-poor growth. On the other hand, special financial programmes can be set up in order to channel resource towards small- and medium-sized activities in the informal urban sector and the rural non-agriculture sector. This is likely to generate a considerable impact on employment creation, income levels and export perspectives. In turn, higher incomes and emersion of informal activities will allow greater sustainability of the local financial systems and a more stable tax base for public budgets.

The resources for implementing microfinance programmes can derive from the contemporaneous use of ODA and private sources, especially commercial banks, private firms and solidarity initiatives. International and local commercial banks could participate in financial programmes launched by international donors, by investing in co-financing the expansion of the local productive system. ODA would provide resources to expand the financial network, and guarantees for the most risky projects alike.

Allowing commercial entities to manage those tailored financial programmes will allow realising efficiency gains in terms of selecting the most promising projects and

minimising the transaction costs of doing it. Private companies in both beneficiary countries and industrialised countries would interact directly with the banks for their entrepreneurial ideas to be realised. While traditional ODA financing would allow for applying lower rates on the smallest firms, the direct participation of international commercial banks and national financial institutions would help building local trust and capacity.

Some banks and investors might also adopt an explicit policy of allocating a percentage of their portfolio on concessional terms for the first years of operation and investing those resources in initiatives that pursue both social and economic objectives. This may give those banks a considerable advantage in terms of reputation. Finally, earmarking the imposition of small taxes on consumption in order to finance development initiatives, as happened with the worldwide mobilisation following the Tsunami, is a still little explored, but indeed promising, channel of development finance that can be further promoted by explicit government measures in donor countries.

2. Overview of international flows of development finance

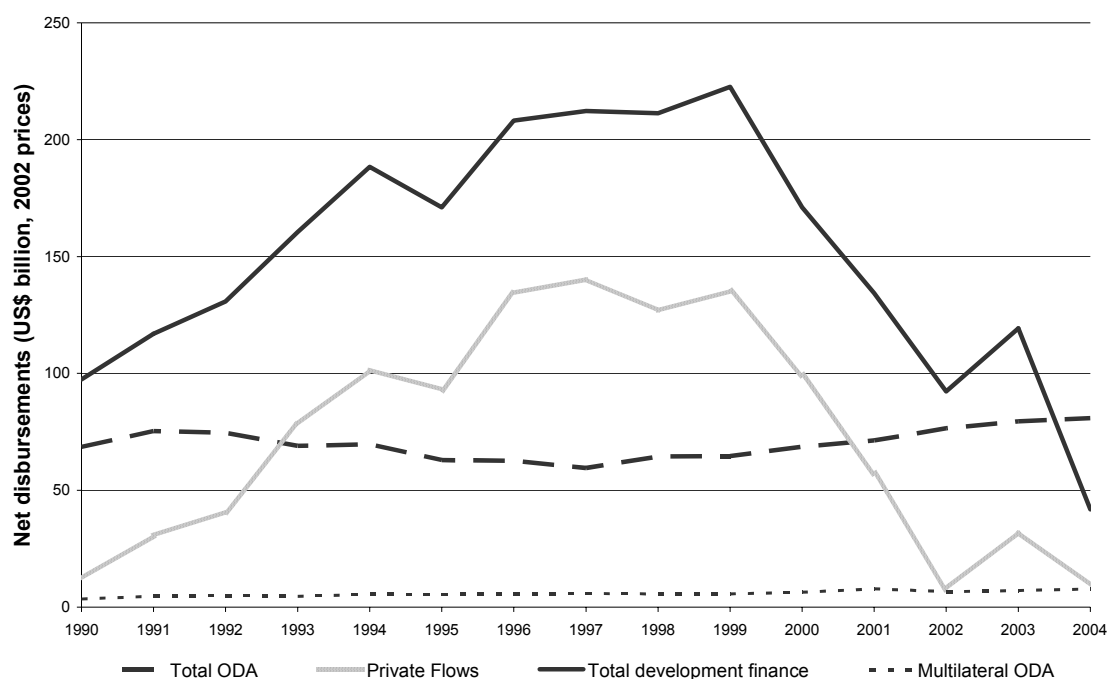
Economic theory and literature has emphasized the importance of foreign capital flows to developing countries, apt to integrate the restricted domestic savings. Capital flows, in combination with trade flows, are seen as prerequisites for sustainable growth and development. Although it is recognized that the savings gap could partly be filled by improvements in public revenue collection, in many countries the bulk of the resources needed will have to be obtained from external sources, and in particular debt relief as well as increases in aid, trade and FDI flows. However, while in the 1960s and 1970s the future of African countries looked bright and promising, since the 1980s the continent has been experimenting a serious deterioration of its economic conditions and an increasing marginalization from the global economy, in terms of both trade and finance (Loots, 2005). The restricted amount and the volatility of development finance, especially private commercial banks, is one of the crucial problems that Africa faces today. Hence, it is essential to begin analysing financial mechanisms by reviewing the trends and composition of foreign financial flows to Sub-Saharan Africa.

2.1 Overall financial resources to developing countries

Figure 1 shows the trend of development finance during the last decade in all developing countries. Overall flows peaked in 1999, reaching US\$ 222.6 billion. However, private flows are very volatile, while ODA is a more stable source of financing. Multilateral ODA is quite constant, although it represents a very modest part of the total. The overall trend of external financing is almost entirely determined by the trend in private flows; these have been quite unpredictable in the last decade.

In particular, two main reversals of the trend in private finance emerge: the steady rise in the first half of the 1990s, when investors regained confidence after the debt crisis of the 1980s; and the sharp decline beginning in 1999, after the years of turbulences triggered by the financial crisis of the middle 1990s. Net private flows peaked US\$ 14 billion in 1997, while five years after, in 2002, registered the lowest amount in the decade, US\$ 7.6 billion.

Figure 1 – Official aid and private flows to developing countries (1990-2004)

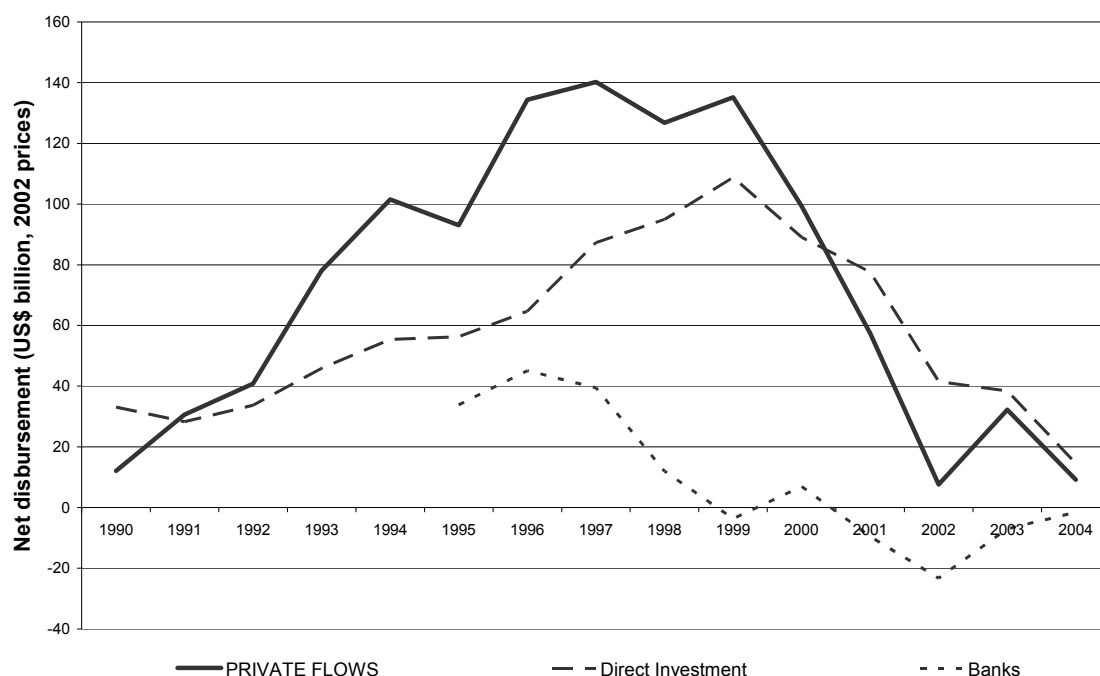


Source: OECD, *IDS Online database*

The cycles of expansion and decline of private flows is the major source of unpredictability of development finance and the signals that investors in emerging markets are highly susceptible to overall trends in world's financial markets. Moreover, private investment has been shown to frequently accentuate, rather than to reduce, macroeconomic volatility. This gives official development finance the clear role of smoothing macroeconomic volatility in shock-prone countries. In the first half of the 1990s, private flows were steadily recovering, jumping from US\$ 12.1 in 1990 to US\$ 140.2 billion and US\$ 135.2 billion in 1997 and 1999 respectively. Thereafter, a sharp decline occurred, with total net private flows reaching their minimum in 2002, falling to US\$ 7.6 billion.

Figure 2 describes the breakdown of net private flows to developing countries by type of sources. It is evident that the two main sources of funding, foreign direct investment (FDI) and banks investment, responded at a different pace to the financial crisis. FDI flows kept increasing up to 1999, peaking US\$ 108.8 billion in that year. Only thereafter, FDI flows started diminishing.

Figure 2 – Private flows to developing countries, by type (1990-2004)



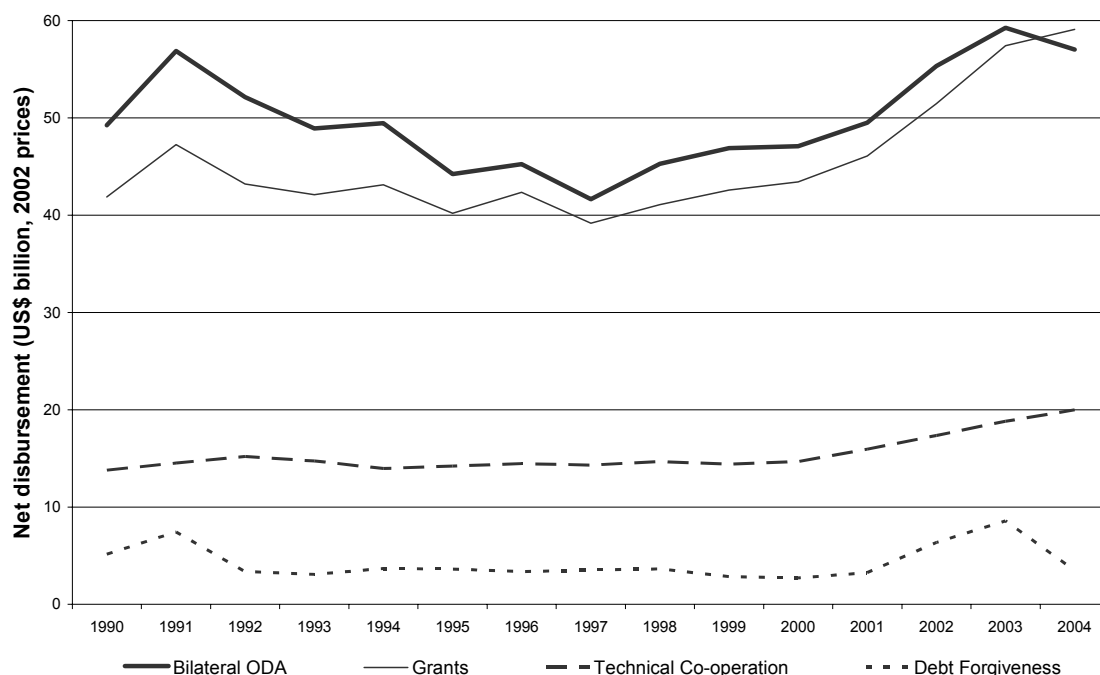
Source: OECD, *IDS Online database*

The other decline in private flows in the second half of the 1990s has occurred in bank financing. Commercial banks were exposed in 1996 for US\$ 45 billion, but reacted quickly soon after the Asian crisis. Lending collapsed, the positive trend ceased, and the net flows (new inflows less debt service and profits) have turned negative in 1999 and then deeply so in 2002. In that year, as much as US\$ 23.2 billion have been transferred back, from indebted developing countries to private banks. Although this trend has been partially reverted, private banks rest the weakest source of development finance, in terms of total resources distributed, and least predictable flow.

As regards bilateral development assistance, which as mentioned above represents the vast majority of total ODA, it sharply declined from the figure registered in the early 1990s: after peaking at US\$ 75.3 billion in 1991, bilateral aid dropped to US\$ 59.5 billion in 1997. While the downward trend for much of the 1990s has now been luckily reversed, since some major donors have increased their aid efforts, the reality is that at the end of 2004 the level of ODA was US\$ 80.9 billion, only slightly higher than 10 years before.

The trend of bilateral ODA in the 1990s is sketched in figure 3, which provides a breakdown by type of flows. The downward trend experienced by total ODA in the middle of the 1990s is even more evident for bilateral ODA, as it is the recover registered in the last few years. However, it is worth noting that grants represent the major component of bilateral ODA, and that the share of grants out of total flows has increased over time. Thus, in recent years, grants rather than loans have been favoured by donors, and the majority of those grants has been directed towards social sectors, such as health, water, and the like.

A revival of loan financing, which is usually related to economic infrastructure and productive activities, is therefore extremely warranted in order to spur growth. As pointed out by Cohen (2005), cancelling debt is good starting point, but the role of soft loans in promoting development and eradicating poverty should not be overlooked. As grants do not require repayment, they might even reduce incentives and undermine development efforts. Moreover, if one of the main roles of ODA is to act as a counter-cyclical device, rising when a country is hit by external shocks and falling in tranquil periods, then the delay between the start of the crisis and the grant disbursement may simply be too long to be really effective. Lines of credit instead may prove to be a more timely way to deal with shocks, as they can be drawn upon rapidly from rolling accounts. Substantial increases in program and project loan financing are thus needed.

Figure 3 – Bilateral ODA to developing countries, by type (1990-2004)

Source: OECD, *IDS Online database*

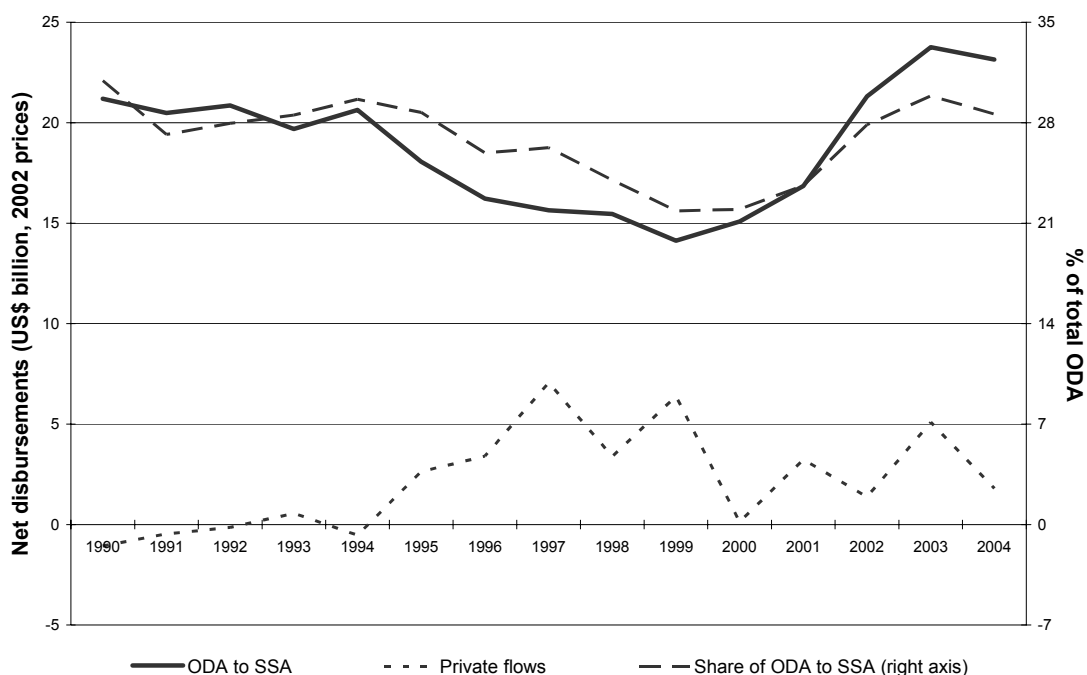
2.1 Foreign flows to Sub-Saharan Africa

Turning to analysing development finance to Sub-Saharan Africa, figure 4 shows that ODA provides the vast majority of foreign resources directed to the continent. Moreover, Sub-Saharan Africa received in 2004 almost 30% of total ODA to developing countries; this share has experimented an upsurge since 2000, hence Sub-Saharan Africa has been the major beneficiary of the recent MDGs-driven recovery in ODA efforts of donor countries. Development assistance thus responds quickly to political impetus.

However, three aspects should be taken into account: first, ODA to Sub-Saharan Africa is extremely concentrated in few countries; second, a large share of ODA grants is allocated to social sectors; third, ODA grants generate what in the literature is called the "aid dependency" of poor countries, that is their almost complete reliance on foreign grants to sustain income levels, rather than ask for loans to use for productive activities.

As regards private flows in Sub-Saharan Africa, these have remained at positive, although low, levels during the last decade, after a period of very modest or even negative transfer lasted until 1994. There has been a peak of US\$ 7 billion in 1997 and another rise up to US\$ 6.4 billion in 1999. Thereafter, private flows have not exceeded US\$ 5 billion, being in addition very highly volatile.

Figure 4 – Official aid and private flows to Sub-Saharan Africa (1990-2004)



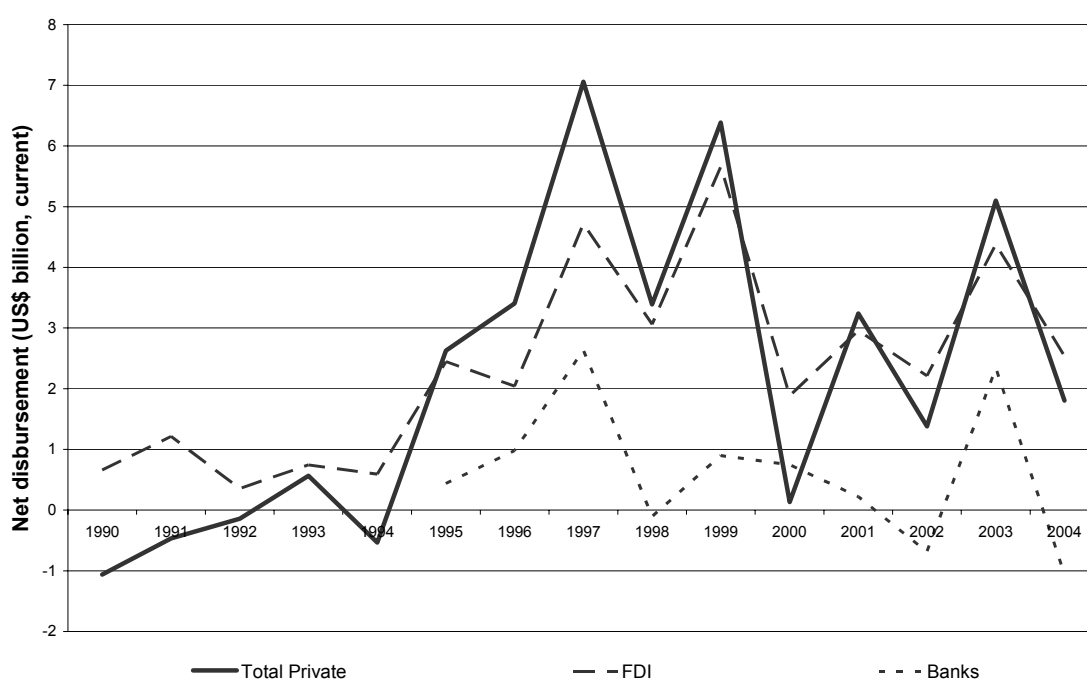
Source: OECD, *IDS Online database*

This phenomenon is more evident in figure 5, where current values, instead of the constant values used in the previous figures, are shown for overall and disaggregated private flows. Total private investment in Sub-Saharan Africa has boomed and busted throughout the last fourteen years, according to the tumultuous conditions of the international financial market. A partial recovery has occurred in the second half of the 1990s, but a very low peak in 2000 has opened the floor for a further period of modest and very volatile growth of private foreign inflows.

FDI is the largest source of private foreign finance, but is concentrated in a few large, resource-rich economies. It is also strongly influenced by a country's investment

climate and the regulatory obstacles to doing business. Banks are very reluctant to lend to African countries and generally accentuate the cycles of inflows and outflows. This gives evidence to the fact that, unless something really new is introduced in the international financial system, private investors will follow perceiving as too high the risk of investing in Africa.

Figure 5 – Private flows to Sub-Saharan Africa, by type (1990-2004)



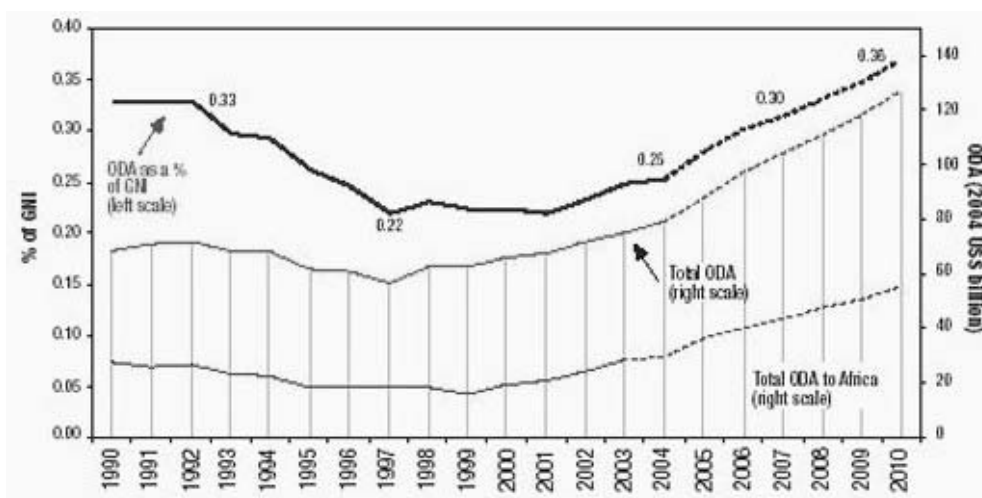
Source: OECD, *IDS Online database*

There is no much doubt about the fact that donors should keep playing a major role in financing Africa's development, but they still have a long way to go if they are to reach the levels they pledged at the UN Financing for Development Conference in Monterrey, Mexico, in 2002. What progress has been made? The recovery in ODA that started in 2001 is continuing, but recent levels and near-term projections fall far short of what is needed to meet the MDGs. The Monterrey pledges are for aid flows to rise to US\$75 billion by 2006, the largest increase ever in aid outlays. But, as points out, attaining this level will depend crucially on future decisions by five major OECD countries, as the funding for 2004 leaves them with a considerable gap to bridge if their commitments are to be met. And even if the 2006 target is reached, aid will still be less

than 0.3% of OECD-DAC members' aggregate gross national income, compared with the UN recommended 0.7%.

On the assumption that OECD donors deliver on their various public statements since Monterrey in 2002, the latest simulation by OECD, reported in figure 5, indicates that ODA will increase from a little above \$80 billion in 2004 to near \$130 billion in 2010, with a doubling of aid for Africa. The projected ODA expansion by 2010 will nonetheless represent the 0.36% of gross national income, therefore it remains well below the 0.50% achieved in the 1960s.

Figure 6 – Official aid, trends (1990-2004) and prospects (2005-2010)



Source: *OECD Observer*, No. 251, September 2005

3. Traditional and new sources of development finance

From the analysis conducted in the previous section, it is evident that most African countries show a high degree of dependence from aid transfers. Almost 90% of foreign capital is official aid, and bank financing on a commercial basis is extremely restricted. These countries are likely to be very exposed to changes in donor's priorities and preferences and priorities, as the downturn in foreign assistance experienced during the 1990s clearly shows. The limited amount of private flows and the volatility of development financing, in supply-constrained countries whose revenue base is further restricted by low income levels, a large informal sector and many weaknesses of the fiscal system, hinder seriously the growth process.

Volatility of financial flows, in particular, has strong negative repercussions in terms of the ability of local governments to plan a comprehensive medium- to long-term development strategy, focused on export competitiveness, employment creation, and poverty reduction (Lensink, Morrissey, 2000). Without an appropriate governance of development finance, apt to guarantee a relative stability of foreign flows, it will be very difficult, if not impossible, to reach the MDGs by 2015. Hence, not only a considerable catch-up in aid and other development flows is of foremost importance, but the predictability of such flows is also an essential requirement.

There are several existing sources of development finance. A well known classification is between official sources, private commercial and private non commercial sources. Official development assistance is one of the chief instruments through which industrialized countries transfer national savings to recipient countries. These transfers occur either by directly executing development projects, or by injecting resources into governments' budgets. Further channels of development finance, whether more or less feasible or easy to implement, have been conceived and proposed in the last decade. Some of them involves official multilateral financing, others are based on leveraging private capital through taxes, financial engineering or lotteries.

However, none of the additional or "innovative" sources of development finance should be allowed to take the attention away from the need to increase official aid. If the donors were able to commit 0.7% of their GNP to development assistance, then the world would be well on the way to finding the finance needed for the MDGs.¹ Hence, the case for improved, effective foreign aid should be strongly supported.

The present section focuses on the main sources of development finance, and starts from analysing foreign aid and debt relief, with a view to suggest possible ways to improve their effectiveness. Afterwards, the actual and suggested instruments for leveraging private financing on a commercial basis will be analysed and commented, with the aim of exploring alternative ways of giving the private sector sufficient confidence to invest in developing countries. Finally, some ways will be recommended to improve the solidarity component of private commercial financing and individuals' donations.

¹ According to official sources, meeting the MDGs requires a financial effort which would cost less than the target of 0.7% of GDP in ODA, set 30 years ago by the DAC and never met by OECD donors, apart from the very few northern-European countries (UN Millennium Project, 2004).

3.1 *Official development finance: effectiveness and targeting*

There are few doubts about the fact that development assistance must increase and should focus on the poorest countries. This is not only recommended by the official statements of almost all international conference, but is also the results of many cross-country analyses and case studies (Collier and Dollar, 2002).

Aid effectiveness in raising income and reducing poverty (either through growth and/or by financing pro-poor public spending) is of course a topic of long-standing and vigorous debate (World Bank, 1998). The majority of existing studies concludes that aid broadly works, that poverty would be higher in the absence of aid, and that the shortfall in aid during the 1990s has, by implication, made it more difficult to meet the MDGs. Hence, a considerable catch-up in aid and other development finance flows is now necessary if poverty is to be substantially reduced in the poorest countries by the MDG target date of 2015 (Addison and others, 2005).

However, aid flows have been associated with low domestic resource mobilization and have reduced most countries to be heavily dependent on aid. In an attempt to improve aid effectiveness donors have used to tie aid, not just to promote commercial interests, but also to link aid resources to particular projects that have direct links with poverty. However, this has not yielded the high economic returns required to sustain strong growth rates of pre-capita income, which is an essential aspect of poverty reduction.

Targeting is frequently advocated as a key policy tool for improving aid effectiveness, both within each country, in terms of focusing interventions to specific sectors and beneficiaries, and between countries. The latter proposition derives from those studies on aid impact that highlight how the effectiveness of development assistance is enhanced in countries with the "right" institutions and policies (Burnside and Dollar, 2000; 2004). This discussion is highly technical and eventually controversial and will be not explored in this document. Though, it should be acknowledged the case-studies and the anecdotal evidence saying that aid has a greater impact in those countries in which the management of the economy is oriented towards growth. Sound institutions and policies therefore have an important role to play in aid effectiveness.

This result highlights the key role that development assistance can play in improving countries' institutions and public administration capacity. Both planning and regulatory skill could sensibly benefit from foreign technical assistance. The major

fields of intervention are such fundamental aspects as rationalizing the fiscal system, reorienting public spending, lowering the red tape, ameliorating the business climate, improving banking and monopoly regulation. However, data show that technical cooperation programmes during the 1990s have been constantly lower in SSA than the average of all developing countries. In the last years technical assistance has even declined, despite the growing trend for all developing countries.

Moreover, donor fragmentation remains high, which can have negative implications for aid quality for several reasons: high transaction costs for recipients because more time is taken meeting donor requirements; too many small projects, with consequent limited opportunities to reap scale economies; and smaller or narrower donor stakes in overall country outcomes.

Given the need for more coordination in the field, there is a strong case for advocating a wider adoption of multi-annual coordinated budgetary instruments, such as multi-donor budgetary support (MDBS), by donor agencies. For instance, the government of Ghana and its development partners has recently agreed on an aid package such as MDBS, which aims at ensuring continuous flow of aid to finance the government's poverty related expenditures. (Quartey, 2005). It is noteworthy to stress also the need to expand the adoption of the harmonised practices for aid disbursement endorsed at the DAC level in the eve of the Rome High Level Forum on Harmonisation held in February 2003 (OECD, 2005).

Another vehicle for foreign aid that has received great attention in recent years is debt relief. The issue has been widely discussed and finally the international community ended up in 1996 with announcing a comprehensive debt-reducing strategy for poor countries, the HIPC Initiative, which is the first serious attempt to rationalize debt forgiveness in a synergic way. It involves multilateral and bilateral sources, as well as official and commercial creditors.

A high level of external debt has been recognised as an important impediment to growth. To this aim, several debt relief proposals are on the table, each involving a different degree of service cancellation and new finance, but there is little agreement among donors on which one is to be preferred. A recent article (Rajan, 2005) points to the need of tailoring the proposals to the very needs of the concerned country. Of immediate importance to a resource-starved government interested in promoting the development of its country is the additional resources it gets in the period, not the amount of service cancellation that, in any case, it would have not repaid.

As remarked in other occasions (Triulzi, 2004), debt cancellation is only a pre-condition for re-launching development in poor countries, but it is not enough to this aim. Moreover, debt relief should be tailored to local circumstances, providing the right combination of cancellations and refinancing. Therefore, debt relief does not eliminate the need for expanding ODA and finding new sources of development finance.

A final suggestion about new possible source of official finance is that the IMF could expand the use of Special Drawing Rights (SDRs), by designing them specifically for development purposes, with donor countries making their SDR originally allocated to the IMF available to fund development. This could make a significant contribution to the overall financing needs of poor countries, estimated in additional US\$ 25-30 billion. However, implementing such allocation requires the ratification by 100 IMF members (85 per cent of the voting power of the Fund), which is a very hard condition to obtain given the particular political momentum of the international financial institutions. Hence, this channel of additional development finance is precluded at the moment.

3.2 Leveraging private resources: the impossible challenge of the existing proposals

While declines in ODA might potentially be mitigated by increases in other inflows, it should be recognised that this possibility is somewhat limited in the case of Sub-Saharan Africa. Many countries in this region will continue to find it very difficult to attract private capital. Not only aid accounts for almost 90% of total foreign flows, but this share has been increasing compared to the 1970s and the 1980s, while private capital flows around the world have grown continuously. Aid dependency and financial marginalisation are thus stark realities in Sub-Saharan Africa, where the need for finance is still largely unmet.

Moreover, private inflows can make it very difficult to carry out the normal tasks of macroeconomic policy and require a very high level of capacity in the governance of foreign capital. Private flows are typically large and volatile, so they can have severe monetary impacts that are difficult to sterilize, given the limited room of manoeuvre available to the authorities in a typical developing country. Inflows almost always cause an unsustainable boom in output, consumption, and asset prices which is hard to accommodate. This in turn provokes exchange rate appreciation and accumulation of debt. Together with the persistent deficits of poor countries in the current account of

the balance of payments, such unstable situation triggers the subsequent reversal of private flows out of the country. And sudden capital flights usually produce sharp and persistent declines in output, with catastrophic consequence on poverty levels (Agostin, 2005).

Therefore, in emerging economies, national policy measures need to be supported by stronger international governance mechanisms for financial transfer, designed to assist countries with those capital booms and downturns that are largely outside of their control. This means ensuring stable and predictable access to source of fresh finance, at reasonable commercial terms, for both the public and the private sector.

Given that the fiscal constraints of industrialised countries hinder a massive expansion of ODA in the medium term, a debate has been steadily building up around what are called "new" or "innovative" sources of development finance, which are essentially based on rising private resources. An UNU-WIDER study (Atkinson, 2004), undertaken at the behest of the UN General Assembly, examined the various possibilities currently available or under examination with the aim of increasing financial flows to developing countries.

The first kind of mechanism to emerge is the introduction of global taxation mechanisms. The best known of these taxes is the currency transactions tax (CTT) – popularly known as the "Tobin tax". Another tax is that on the use of hydrocarbon fuels according to their carbon content. A proposal from the French government (Landau and others, 2004), considered also a tax on airline fuel. These taxes have double dividends, respectively that of reducing excessive currency speculation, mitigating global warming, and lowering hazardous emissions. According to the recent estimates, a Tobin tax could generate US\$ 15-28 billion per year, whereas a carbon tax could raise US\$ 50 billion.

Another suggested mechanism is the International Finance Facility (IFF), a proposal of the UK government launched in January 2003 (HM Treasury, DfID, 2003). The IFF would be designed to act as a complement to donors' long term commitment to achieve the 0.7% ODA/GDP ratio. It would be a temporary mechanism designed to "frontload" donors' commitments by leveraging funds through a bond placed on the international capital market. This would make available from the outset all the resources needed for development purposes. The bond would then be repaid by donors in a period of 30 years or so. It would not be a new agency, but it would rather disburse

funds through existing bilateral and multilateral mechanisms. The IFF would leverage additional money from the international capital markets (through a securitization process); it could achieve a flow of \$50 billion during the crucial years 2010 to 2015 (that is, up to the target date for the MDGs), building up from 2006 and falling to zero by 2020.

Finally, other means of development finance that have been proposed in recent years are: facilitating remittances, organizing a global lottery, and selling a global premium bond. In 2004, remittances amounted to US\$ 125.8 billion for all developing countries, but to only US\$ 6.1 billion for Sub-Saharan Africa (World Bank, 2005c). A reduction in transfer costs, especially for poor countries, may help meeting the MDGs, since remittances flow directly to households and communities. A global development lottery could perhaps raise an annual \$6 billion by taking a slice out of the world gambling market which is a \$1 trillion per year business, especially if buyers of lottery tickets take the view that financing development is a better use of their money. A global premium bond would follow the modus operandi of the UK premium bond scheme whereby the bonds are entered in a monthly prize draw with no loss of the initial investment; this could constitute an attractive ethical investment product.

But, what level of agreement is necessary for the implementation of these proposals? The agreement on the Tobin tax has never been reached and the main opponents are the financial institutions themselves, those that should implement it (Reisen, 2002). Other taxes, although promising from a revenue-raising perspective, require a large amount of international political agreement. Only a smaller subset of countries can implement the IFF and this is one of the scheme's big advantages over global taxes. However, it seems that the IFF is inconsistent with the budgetary procedures of some donor countries (Addison *et al.*, 2005). It will also have to be examined more thoroughly whether the initiative is not in conflict with constitutions in donor countries as it shifts some of the funding burden from current governments and generations to the next (Reisen, 2004).

A lottery for development purposes could be introduced by individual countries as could a global premium bond, but these may be opposed by the beneficiaries of existing national lotteries, including domestic charities as well as commercial gambling operators. A global premium bond would compete with the existing UK premium bond market, which funds general government expenditures. Ethical investors may prefer a

global premium bond to UK ones for the developmental ear-marking, thus oppositions may arise.

It is also essential to further exploit the potentials of philanthropy by individuals and firms, as a source of additional development finance. Solidarity giving can be increased by tax incentives and corporate giving. The recent response to the tsunami disaster in Asia illustrates the potential in this area. Philanthropic measures can be purely private initiatives, but they would benefit greatly from government support and help. For instance, a small, diffused tax applied in industrialised countries on the consumption of particular commodities, earmarked to proposed development initiatives, has great potentials to succeed.

An illuminating example is what is being done in the Tuscany Region in Italy, where water providers, with the support of the regional government, tax users € 1 cent per cubic meter of delivered water, in order to raise funds for water projects in developing countries. The outcome of the first year of application of such "solidarity tax" has been a sum of € 900.000, which is now flowing to the water sector in poor countries. It has been estimated that, if applied at the national level, the application of such tax in the whole Italian territory would raise € 1 billion. Other proposals follow this approach in suggesting that a small tax can be applied to each euro invested in the production of weapons. This tax would raise up to € 9 billion worldwide, to be invested in pro-peace initiatives.

In summary, some proposals require a high level of international unanimity, while only some can be introduced by a sub-set of countries or individual countries. In any case, politics will play a decisive role, including political mobilization at both national and international levels. However, the main weakness of the proposed mechanisms is that private participation in development finance is only indirect: private sources are conceived as merely a way of leveraging fresh money, not an opportunity to ameliorate the entrepreneurial climate of recipient countries.

Instead, the private sector still has a major role to play in trying to develop creative and workable development proposals. According to this perspective, the view suggested in the present document is that what is extremely needed to boost development finance is a truly innovative and systematic way of managing sources, destinations and channels of delivery, including wider participation of the banking sector in directly financing directly productive initiatives.

3.3 *The need for linking development finance to pro-poor growth*

Three determinants of the effectiveness of growth in reducing poverty have been highlighted in the studies about Sub-Saharan Africa: generation of productivity gains in the agriculture and rural sectors, enhancement of productive capacity, and management of aid inflows (Pattillo *et al.*, 2005). Instead, in the last decade the whole development policy, including foreign aid, has tilted toward the social sectors, assuming that the private capital would alone bring about all the capital required for renewing productive opportunities.

Scaling up of development assistance will be effective only if poor countries have adequate capacity to absorb more aid. Capacity constraints to effective absorption of foreign resources can manifest themselves at a number of levels, from national policy and public budget management to local service delivery, and in various ways, including macroeconomic management, institutional capacity, infrastructure, human capital, social, and cultural factors. But not all constraints are equally binding; some can be eased in the near term, while others may take longer. Moreover, changes can be mutually reinforcing, with improvements in one area serving as a catalyst in others. All these aspects imply that sequencing is central to capacity building: interventions across the range of constraints should be prioritized, and investment aligned with those priorities.

While recognizing the fundamental role played by social policies in poverty alleviation, it should be noted that countries in SSA receive little money from foreign private sources and are particularly constrained by lack of domestic credit. Financial constraints on the absorptive capacity makes small- and medium-sized productive activities, which are the centrepiece of pro-poor growth, very vulnerable to the domestic business cycle and the prevalent climate of international capital markets.

So, the question remains about where to allocate development finance to enhance growth perspectives and poverty alleviation. Pro-poor growth can be defined as concerning the ability of the poor to participate in a country's economic progress, hence an assessment of whether a policy is pro-poor or not should focus on its impact on specific productive opportunities. Labour-intensive growth should occur mainly in those sectors where the poor are employed. Therefore, in order to enhance poverty reduction and raise the incomes of the bottom quintile, besides social policies and tar-

geted alleviation programmes, small- and medium-sized entrepreneurship should be promoted.²

Promoting the development of informal productive activities and fostering their emergence into the formal sector appear to be very effective measures. This will have two complementary outcomes: on the one hand, it would directly rise income and expand employment opportunities for the poor; on the other hand, the tax base would also enlarge, in so creating more room for implementing accompanying social policies. Hence, such a policy will generate sustainable resources for providing social services and eventually will lower the related costs by expanding physical infrastructure, making it easier to achieve the social MDGs. However, small- and medium-sized enterprises in poor countries are exposed to a considerable risky environment and a series of productive bottlenecks that prevent them to grow and flourish.

Hence, the target of development finance should be reducing those productive bottlenecks, in order to raise productivity throughout the economy and improve the supply response. One of the most serious bottlenecks that has been repeatedly noted by the literature is the weaknesses of the financial sector in many African countries. This limitation has acted as a major source of vulnerability to shocks and have literally encumbered private sector growth. According to the World Bank's *Country Policy and Institutional Assessments* (CPIAs), which include an assessment of the policy and institutional framework governing the sector, a sizable proportion of low-income countries has unsatisfactory ratings with respect to financial sector management. In Sub-Saharan Africa, this proportion is still higher. Actually, the many weaknesses that have been recognised in the financial sector of African countries, apart from poor legal environment and weak bank oversight, can be traced back to the enduring bank crises, the concentration of the banking sector, and the persistent public intervention in the financial market (Kpodar, 2005).

Both the poor and the small- and medium-sized enterprises are traditionally at a disadvantage in obtaining access to local credit, especially long term loans, implying the need for special attention to policies to facilitate broader access to financial services. Financial sector deepening and development benefit both the poor and the small economic activities alike, which usually faces wider and higher spreads, because of

² It has also been shown that, when aid is used to enhance the supply response of the few firms that can export, the poor gain more through the spill-over in the job market. Indeed, productivity gains from export growth have been pointed as the key missing driver of growth thus far for most SSA economies (Collier, O'Connell, 2004).

their structural lack of collaterals. Therefore, it is essential to put in place regulations that foster competitive access to credit and laws on asset registration and collateral.

A recent study on household and firm use of banking services relates banking outreach indicators to measures of firms' financing constraints (Beck *et al*, 2005). The study finds that firms in countries with higher branch and ATM penetration and higher use of loan services report lower financing obstacles, thus linking banking sector outreach to the alleviation of firms' financing constraints. Greater outreach is also correlated with better communication and transport infrastructure and better governance. Government ownership of financial institutions translates into lower access, while more concentrated banking systems are associated with greater outreach.

Taking the previous considerations into account, a twofold strategy for boosting development finance and enhancing its effectiveness is suggested in the two following sections. On the one hand, a more holistic intervention is recommended in setting up and operate microfinance institutions, since this would deepen poverty outreach and help to better focus on disadvantaged categories, such as women. An effective and transparent public support to foster a massive expansion of financial institutions is extremely needed in many African countries.

On the other hand, it is suggested to explore the likely synergies between official aid and private commercial and not-for-profit foreign capital. The idea is to implement special financial projects directed towards small- and medium-sized enterprise, which are the key potential source of dynamism for Africa's economy. The suggested mechanism would take into account the need of reinforcing local financial institutions and would exploit the advantages of involving foreign and local commercial banks directly into aid-driven development projects.

4. Microfinance: financial services for the poor

About 500 millions of economically active poor people in the world are estimated operating micro-enterprises and small business (Women's World Banking, 1995). The vast majority of them have no access to the formal banking system essentially for lack collateral, high transaction cost per loan while serving small scale projects and high risk of targeting potential clients mainly poor and operating in the informal

sector. A set of innovating financial institutions, called Microfinance Institutions (MFIs), providing financial services to low income households, even the extremely poor, are developing a participatory and non-paternalistic development approach spreading out excitement across the donor community, policy makers, development researcher and practitioners in the past years.

Microfinance is a unique tool in development intervention, pursuing the goal of poverty alleviation in low income countries in a sustainable way, despite most of MFIs still rely on subsidies (Armendariz de Aghion, B. and Morduch, J., 2005). These conclusions are supported by empirical studies that find a positive correlation between financial sector deepening and income growth of the bottom quintile of the income distribution (Tsangarides et al, 2004; Beck et al, 2004). Moreover, microfinance institutions are recognised as a key source of pro-poor growth (Khandker, 1998).

The term microfinance refers to the provision of a range of financial services, including loans and savings facilities, insurance, transfers payments and even micro-pensions to people excluded from the formal financial sector. Many MFIs provide also social intermediation services such as group formation or development of self-confidence, enterprise development services such as business management and book-keeping training, and social services such as education, nutrition training and health care.

MFIs' clients use financial services not only for working capital and business investment in their microenterprises but also to invest in health and education, to smooth consumption, to manage household emergencies and to meet all other cash needs they may encounter. MFIs decision to offer non-financial services determines whether they are minimalist or integrated.

MFIs assume different legal status according to the local regulatory framework constraints, donors pressure or institutional strategic choices: they can be non-governmental organizations (NGOs), savings and loan cooperatives, credit unions, government banks, commercial banks, or non-bank financial institutions.

Microfinance reach a wide range of beneficiaries, typically self-employed, low-income entrepreneurs in both urban and rural areas.

The idea of lending to low income households translated into different mechanisms, the most celebrated of whom is the solidarity group scheme (Morduch, 1999). Group lending contracts make borrowers jointly liable of each group partners' loan, mitigating informational asymmetries problems through peer selection and monitoring,

and social enforcement. Microfinance programmes also use: dynamic incentives such as increasing loan size amounts upon satisfactory repayment and focus on more creditworthy and reliable women clients (assuming women's "culturally patterned behaviour"³, lower mobility and fewer alternative borrowing possibilities than men); regular repayment schedules starting almost immediately after loan disbursement, as a mean to screen out undisciplined borrowers; and collateral substitutes such as compulsory savings, emergency and group fund, providing insurance in case of default or additional funding to group members.

4.1 Microfinance as a poverty-alleviation strategy

Microfinance is considered an important tool in the mission of poverty eradication because it empowers people, providing them not only financial means but also confidence, self-esteem in order to encourage them to play a larger role in their development.

Providing financial services includes providing the financial means to save, to access credit, and to start small businesses, with the potential to reduce poorest vulnerability and to enhance community development, in order to contrast the "poverty cycle" caused by the lack of saving and access to finances that tends to create a state of perpetual scarcity and also to repress people's potential to improve their livelihoods.

It's possible to find out two different but simultaneous levels of intervention of microfinance on poverty reduction: at first microfinance tries to contrast the "material" poverty playing an effective role in helping people become more economically secure, giving them the means to improve their own household welfare, such as food security, nutrition, health and education services. Becoming more productive, increasing their income the clients are able to accumulate savings for other investments and emergencies for important household expenditures (such as school fees and funeral costs) and for crises (such as illness, natural disaster, or theft). On the other hand microfinance tries to contrast also the so called "no-material" poverty or better to eradicate social and psychological effects that prevent people from realizing their potential. From an individual prospective microfinance programs usually raise the self-esteem and status

³ Rahman (1998) study on Grameen Bank female clients in Bangladesh point to these complementary cultural forces.

of clients in societies where they are often treated as second-class citizens because they allow them to earn steady income, to have a savings account, to attend training courses, and to prove their ability to repay loans. On the other hand Microfinance Institutions (MFIs), adopting group lending mechanism to provide training in financial management, legal rights, business management, also indirectly originate among clients principles of collective organization and solidarity. Specially women are often empowered to speak out more, to assume leadership roles, and to eventually denounce violence suffered. For many of them, the group is the first opportunity to meet other women to discuss problems, to develop joint action and to share information. So also through this channel microfinance initiatives individually and collectively empower people.

Finally, microfinance in order to achieve a sustainable and effective impact on poverty eradication should create a private sector of entrepreneurs able to work in the formal economy. In other words, microfinance should be a tool for promoting a formalization of the informal sector throughout the empowerment of micro-entrepreneurs who are seeking to pass from the survivalist profile to the more secure formal sector of the economy.

However it's important to remember that microfinance is only one of many alternative or complementary intervention strategies designed to alleviate poverty, generate income and promote employment. Microfinance is not a "one size fits all" intervention solution but it's important to carefully evaluate the alternatives and choose the most appropriate intervention tool for a specific situation because anti-poverty programs need to be comprehensive, integrated in national economic policies and to focus on building national capacity for pro-poor policies and institutional reform.

For this reason the research is an invaluable tool to better understand and support microfinance initiatives. An analysis of the local microfinance environment, (i.e. population, culture, natural resources, and economy), helps to promote microfinance strategies that complement these realities, utilizing assets of the area, and reinforcing the capacity for social, economic, and organizational innovation. An understanding of how microfinance initiatives impact poverty eradication necessitates a definition of poverty that corresponds to a local definition of wealth. In many cases also a simple pool of trainers from the local population, who are familiar with local languages, customs, and social norms can perform better because they are familiar with the area and local community.

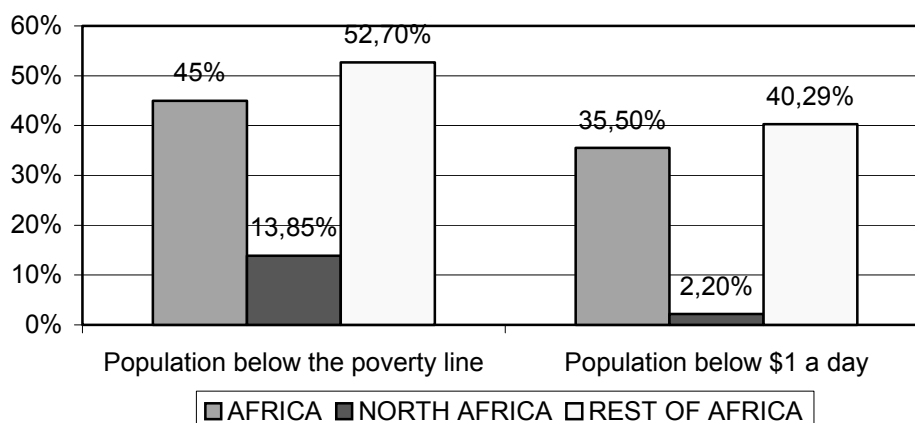
4.2 Microfinance in Africa

Microfinance in Africa is as heterogeneous as the continent itself. A wide range of approaches have been used, from traditional kinship networks and Rotating Savings and Credit Associations (ROSCAs) to NGOs and Cooperatives arrangement, both funded by national governments or international donors.

African people with no access to economically productive resources, which include financial services, rely mostly on subsistence agriculture and/or small income-generating activities of the local informal sector. Lack of financial services access exacerbates the poverty cycle restricting people's potential to improve their livelihoods.

The World Bank estimates 316 million people or 35,5 percent of the African population lives on less than \$ 1 a day while 40,29 percent of the population lives below the national poverty line (see figure 6). But there are consistent differences in such a big continent. In fact, if we concentrate only on North Africa (Algeria, Egypt, Libya, Morocco and Tunisia) the national poverty rate, that is the percentage of population living below the national poverty line, is more the 3 times less than the African average (13,85%) and also people living on less than \$1 a day represents only the 2,2% of the North African population.

Figure 7 – Poverty in Africa, 2001

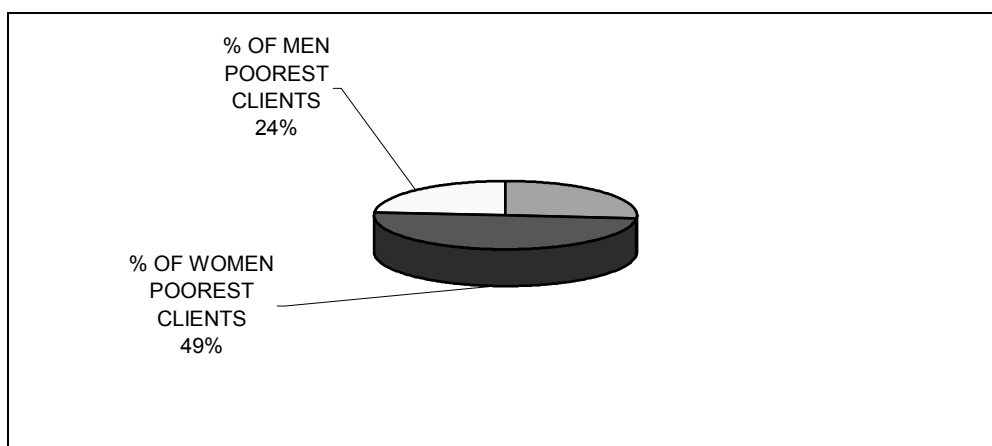


Source: World Bank, *World Development Indicators 2005*

The State of Microcredit Summit Campaign 2004⁴ (Daley-Harris, 2004), reports 919 institutions operating in Africa (that represent the 31% of all the institutions reported in 2004). MFIs located in Africa in 2003 reached almost 6,5 million of people among which 4,7 millions are considered poorest according to the Microcredit Summit definition that includes the bottom 50% of those living below their country's poverty line and those living on less than \$1 a day adjusted for purchasing power parity (PPP). This shows how MFIs try to target not only the less-poor more capable of repaying loans but the poorest of the poor that are the most exposed to social and economical exclusion even if it may imply problems of financial and operational self sustainability.

Among the poorest more than the 67% of the clients are women, or better in 2003 MFIs reached 3,180 poorest women in Africa. This confirms that also in Africa women are reliable and creditworthy clients as they perform higher return on loans and they are more responsible managers of financial resources. Furthermore, they use their loans for the benefit of their household rather than self-gratifying consumption (as common among men) generating a virtuous circle of increasing family income and encourage the improvement of social and economic conditions of the whole community.

MFIs' clients in Africa



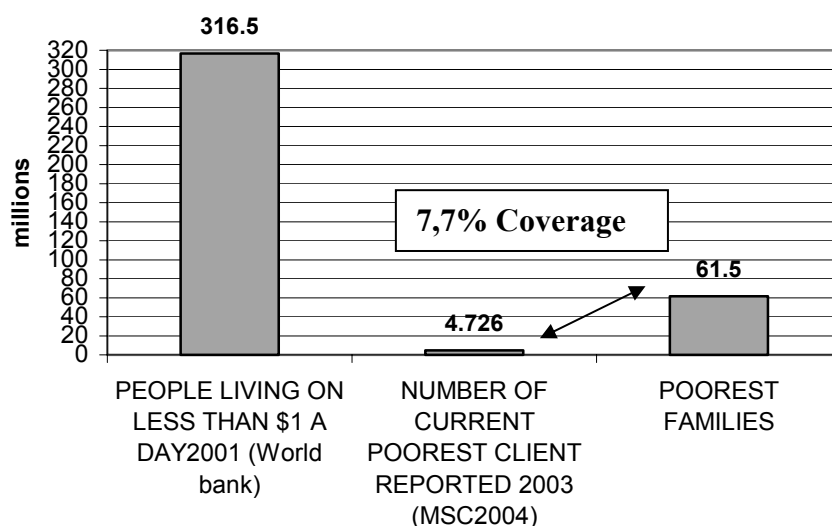
Source: 2004 State of Microcredit Summit Campaign

⁴ Microcredit Summit Campaign is a nine-year global campaign involving main microfinance actors around the world. Data quoted refer to its last annual survey of microfinance programmes involved (2.931 MFIs around the world). 2005 State of the Microcredit Summit Campaign Report with updated figures will be released on December 7th.

Combining World Bank regional data about population living on less than US\$1 a day and MFIs' poverty outreach in Africa it is evident that microfinance help an extremely small share of poor people (figure 9); though microcredit is an individual small loan, usually it is mainly used for new business start-up and involves all the household and sometimes also other members of the community, thereby it is more correct to compare the number of families that live on less than US\$1 a day (almost 61,5 millions of families according to the World Bank, 2005a) and the number of clients reached by MFIs as a proxy of the loans allocated.

Following this approach the microfinance sector serves 7,7% of the poorest in Africa providing them financial tool for empowering themselves. Therefore, in order to improve microfinance industry depth and breath of outreach, both national and international actors should promote networking and cooperation in order to exchange knowledge and experience among African microfinance practitioners through Internet, dissemination of written material, field level practitioner exchanges, best practice workshops and conferences that could bring together microfinance policy makers and leaders in order to identify a microfinance methodology-model adapted to Africa's specific needs for poverty eradication among the different approaches.

Poorest people access to microfinance



Source: State of Microcredit Summit Campaign, 2004

A recent analysis carried out by Microfinance Information eXchange (Anne-Lucie Lafourcade et al., 2005) on social and economic performance of MFIs in sub-Saharan Africa design a mixed picture of African microfinance sector⁵. According to geographical location, 66% of MFIs reported are in East Africa (Ethiopia, Kenya, Tanzania, and Uganda) and West Africa (Benin, Ghana, Guinea, Côte d'Ivoire, Mali, Nigeria, Sierra Leone, Senegal, and Togo) while in East Africa the wider share of borrowers and savers are concentrated due to the presence of two very large borrowing institutions in Ethiopia (Amhara Credit and Savings Institution ACSI and Debit Credit and Savings Institution DECSI) and the largest savings institution in Kenya (Kenya Post Office Savings Bank KPOSB): the 52 percent of all savers and 45 percent of all African borrowers.

In Africa very different actors operate in the microfinance industry: from the formal sector such as banks, regulated non-bank financial intermediaries, regulated NGOs to financial cooperatives and credit unions and unregulated NGOs or non bank financial intermediate. Unregulated MFIs perform worse than the regulated ones and cooperatives in terms of breath of outreach, as number and amount of loans allocated are much smaller. Nevertheless they seem to target most vulnerable people such as women and/or low income households, as among almost half of the reported unregulated MFIs more than 70% of the borrowers are women⁶.

The main MFIs' feature in Africa, unlike MFIs in the rest of the world, is that they serve more savers (6.3 million) than borrowers (2.4 million) because they traditionally have a strong focus on savings services.

The weighted average loan per borrower is \$307 even if it depends on the region (the average loans goes from \$468 in the Indian Ocean area to \$175 in East Africa) and on MFI legal status (for the unregulated MFIs the average loan is only \$186). The average savings balances are \$ 137.

Little we know about the type of programs used in Africa. The MicroBanking Bulletin (2005) indicates that more than 85 percent of its African sample offers group loans through solidarity groups or village banks.

⁵ The MIX survey monitored 163 African MFIs located in 25 countries, including regulated (commercial banks, regulated NGOs and non-bank financial intermediaries) and unregulated (MFI projects and others) institutions, and Cooperatives.

⁶ MIX definition of "low income" differs from Microcredit Summit one quoted above. "MicroBanking Bulletin's definition of institutions reaching the low-end of the population is measured by an average loan size of less than 20% of GNP per capita or less than US\$150" (Daley-Harris, 2003).

5. Enhancing development finance: what role for public policy?

As shown in the previous sections, countries in Sub-Saharan Africa suffer a substantial marginalization from global financial flows. In particular, the resource gap to be closed in order to reach the MDGs is huge and still uncovered by conventional sources of development finance. Foreign aid can play its role, but the current fiscal constraints of industrialised countries impede to reasonably expect that a radical upsurge of official finance will occur in the near future. Moreover, aid is usually allocated to social sectors, while the decline of resources available to productive activities makes it difficult for these countries to undertake a sustainable economic development based on productive activities. Hence, involving the private sector, in both providing development finance and undertaking special private development initiatives, is key to re-launching the growth process in Africa.

A possible starting point for a modern strategy of development finance could be addressing the weaknesses of the financial system in African countries. Historically, the main reason for strict financial control by government entities was a desire to stimulate investment by keeping interest rates low and provide cheap capital to strategic firms. However, the effect of this policy has been to discourage savings and encourage capital flights. At that artificially-low interest rates, the excess demand has been controlled through rationing, that favours large borrowers with political ties, at the expenses of small- and medium-sized initiatives, where transaction costs and perceived risk are likely to be higher.

Therefore, a massive expansion of financial institutions is extremely needed in many African countries. In the present document, we pursue two possible lines of intervention along this way of reasoning: strengthening microfinance institutions and devising special programmes to channel credit to small- and medium-sized enterprises.

5.1 *Strengthening the role of microfinance institutions to eradicate poverty*

The arguments against state-supported banks dominated microfinance policy early discussion during the eighties. Donors enthusiastic support to the first wave microfinance movement and program replications around the world still rests on a "win-

win" proposition: MFIs financially self-sustainable are able to reach a larger scale and, thus, alleviate the most poverty. This view of microfinance was strongly influenced by the Ohio State University (Adams *et al.*, 1984), and is supported by key donors community actors, as US Agency for International Development (USAID) and Consultative Group to Assist the Poorest (CGAP). According to a 1995 set of influential "recommended standards for support to microfinance", known as "Pink Book", subsidies to MFIs should be phased out at the latest 10 years after start-up as "international experience shows that successful intermediaries have achieved operational efficiency in three to seven years, and full self-sufficiency, i.e., covering all financing costs at non-subsidized rates within five to ten years"⁷.

Microfinance capacity to serve poor households through operationally sustainable and financially viable organizations, as well as the trade-off MFIs face between social objectives and financial self-sufficiency, have been always debated in the field. Nevertheless most of ongoing programmes remain substantially subsidized, and those serving the poorest cover only part of their full costs.⁸ According to the Microbanking Bulletin (2003),⁹ just little over half of the self-selected group of programmes surveyed was composed of financially sustainable MFIs, while focusing on lenders targeting "low end" clients, above proportion decrease to 37%.¹⁰ Is there a case for donors support to poverty oriented MFIs?

Local market conditions seem to play a role as well in institution's efficiency. Population density, quality of infrastructure, and client's degree of homogeneity affect MFIs ability to reach financial viability, while location between rural and urban environment seems constrained by several factors. Given less favourable market conditions and fragile environment, do MFIs operating in rural areas may ever reach full financial independence? Does client's field of activity is more crucial?

Mainstream microfinance vision privileged so far a minimalist approach (limited to provision of financial services), given ongoing subsidies requirement of the integrated approach (offering financial intermediation and other services).

⁷ See: www.gdrc.org/icm/inspire/donor-guidelines.html, reformulated and endorsed by member state leaders of G8 during the June 2004 summit at Sea Island, United States (CGAP, 2004).

⁸ Some speculations circulated widely in microfinance circles based on anecdotal evidence suggest that less than 5% of worldwide MFIs are currently operating with financial self-sufficiency.

⁹ See www.mixmbb.org.

¹⁰ MBB database includes only institutions indicating a strong commitment toward financial autonomy, voluntarily submitting their financial informations.

A more holistic intervention seems to deepen MFIs poverty outreach and helps better to focus on disadvantaged categories, such as women. Do non financial services matter in terms of poverty orientation and what are the implications on MFIs operational and financial self-sufficiency?

After twenty years of "best practice"-led microfinance, a scope for an open debate over the role of public policy has gradually emerged in practitioners, researchers and policy makers agenda. Therefore, an effective and transparent public support to foster a massive expansion of financial institutions is extremely needed in many African countries.

5.2 Devising special credit programmes for small- and medium-sized enterprises

It has been show above that, besides operating in the social sector, which is directly related to poverty eradication, it is essential for Africa's development to increase financial inflows for productive development projects. It is nonetheless equally important to make better use of mechanisms that are already put in place by donors and private investors, in order to economise in the costs of setting up new international financial tools.

The new strategy should be based more on combining different existing sources of development finance, in order to jointly undertake special programmes that would utilise the instrument of credit to promote a wider diffusion of small- and medium-sized enterprises. In particular, commercial banks and private firms, in both industrialised and developing countries, can be partners of development programmes launched by donor agencies and beneficiary governments. Each actor would keep playing its own role, but would nonetheless coordinate with the others, in a novel way of joining the financial efforts.

The final goal is to make existing sources of development finance work more effectively, through the joint use of several complementary mechanisms. It will be shown that this goal might be reached through an integrated financial strategy. The proposal can be also a win-win solution, because it is based on what currently done by some donors, while incorporating a novel sense of international solidarity, responsible investment, co-participation in the development efforts, and risk-sharing between public and private actors.

The innovative idea developed in this paper is to launch special credit programmes in Sub-Saharan Africa, co-financed by donors, local governments and commercial banks operating in both industrialised and developing countries. The aim would be co-financing a network of financial institutions that would assist small- and medium-sized enterprises to undertake local development projects and to develop innovative entrepreneurial ideas. These development programmes would be jointly conceived and implemented by donors, local governments, banks and the private sector. A wide partnership can have a significant advantage, in that it would build upon the skill and experience of banks in selecting the most promising projects, also with significant benefits in terms of improved capacity of local institutions and private companies. The programme effectiveness would be also enhanced greatly by the participation of local finance, in that it would be better able to target the informal sector of the economy.

Therefore, we imagine with this proposal a new role for major international agencies and bilateral donors. That is providing financial assistance to those special credit programmes, aimed at building a "basket" of financial resources and capacities to be invested in poor countries. The development cooperation would make available some additional resources to those investors, both during the initial period (research, specialised training, etc.), and for the start up of the projects. The help of commercial banks would, instead, be determinant in catching up the financial resource and selecting partners and projects.

Major international donors, such as the EU, could create dedicated budget lines, open to partnerships between commercial banks of both industrialised and developing countries. Bilateral development cooperation can implement such programmes too, since local donor agencies can assist domestic banks in creating a partnership with local financial institutions, with the same objective of promoting economic cooperation, local entrepreneurship and internationalization of productive systems. This strategy will also reactivate the channels of soft loan, which as seen has been overlooked in recent years in favour of ODA grants. For example, in Italy the Rotating Fund established by Art. 6 of the Law 49/1987 is an underused tool of development loans, which would instead be well placed to work along this proposal.

One could not expect, anyway, that banks will be willing to invest more in Africa just because they would co-finance donor-driven projects. Two additional elements should be strengthened in the international financial system in order to reach even more integration and synergies.

The first additional element of the proposed strategy is to reduce the risk of investing in poor countries. The main obstacles to international investment of small- and medium-sized enterprises in poor countries are the limited expected commercial attractiveness and the low financial viability of private projects in the early years of operation, before the plants get into full operation and reach financial sustainability. To overcome such obstacles, development guarantees seem a very promising instrument for reducing investment risks in poor countries. A recent study of the Development Centre of the OECD have analysed in depth the potentials of using donors' guarantees to support development projects promoted by the private sector (Winpenny, 2005).

Not to be confused with export credit guarantees, development guarantees, which are already used by all international organisations and few major bilateral donors, are designed for financing infrastructure in emerging or developing economies where risk is a deterrent to lending or investment. According to the OECD study, from January 2001 to June 2003 guarantees issued by international organisations rounded US\$ 5 billion, the major part coming from the World Bank's Multilateral Investment Guarantee Agency (MIGA). The level of bilateral guarantees has been estimated in US\$ 200-300 billion annually in recent years. The presence of guarantees from multilateral or bilateral agencies can encourage financial flows either to increase or to go where they otherwise might not. In this way, they can have a positive effect on sovereign ratings as well as their immediate direct effect on the local development environment. As a bonus, development guarantees can help stimulate and stabilise local capital markets, thus providing future benefits for other investors, both public and private.

The second additional element of the proposed integrated strategy is to improve the planning and budgetary process in recipient countries and to link it firmly to ODA commitments. This will both ensure more predictability of aid inflows, and provide for mechanisms of coordination between donors and local actors.¹¹ Multi-donor budgetary support (MDBS), such as that launched in Ghana, are very effective tools, which can nonetheless be improved by enlarging the partnership that supports the process. This partnership should necessarily include the productive and financial sectors of both donor and recipient countries, in order to adapt the investment plans to local circumstances.

¹¹ Several recent studies have reviewed budgets in highly aid-dependent countries to assess how Poverty Reduction Strategies (PRSs) have helped improve aid delivery. The studies have found that the PRSs have fostered improvements, though there is much room for further progress (World Bank, 2005c).

6. Conclusions

The existence of a gap in the amount of resources needed to finance the MDGs has generated a rich debate around the mechanisms that could be put in place to enhance development finance. Given the current constraints on public budget in donor countries, it is expected that additional resources would originate especially from private sources. However, especially in SSA, private flows are low and volatile; in particular, commercial banks have been very reluctant to invest.

In order to attract private capital, Sub-Saharan countries need to accelerate reforms to enhance their investment climates. They also need to scale up investments in basic infrastructure. Over time, such changes will attract more private investment. But in the near to medium term, increases in ODA will remain critically important for the region. However, current and near-term projections of development assistance fall far short of what is needed to meet the MDGs. Although recent estimates of the additional resources vary widely, they all point to a significant financing gap. Clearly, many low-income countries do not have sufficient domestic resources or access to global financial markets to finance such investment. More aid will be critical to accelerating development.

In the present document, two possible lines of intervention have been suggested. On the one hand, it is essential to further microfinance programmes as a tool for direct poverty eradication. On the other hand, special integrated credit programmes can be launched for financing entrepreneurial projects of small- and medium-sized enterprise.

The idea is much in the spirit of creating a special Public-Private Partnership (PPP) between, on the one hand, donor agencies and national governments, while on the other hand between commercial banks and private firms in both donor and beneficiary country. This PPP would focus on developing entrepreneurship at the local level through a network of financial institutions and donors dedicated to finance the projects proposed by small- and medium-sized enterprises.

The suggested measures have great potentials to stimulate pro-poor growth, both directly, through increases in the amount of capital available for local productive investment, and indirectly, through transfer of managerial and technological skill between banks.

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