Deutsches Institut für Entwicklungspolitik

German Development Institute

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Briefing Paper 23/2015

Financial Stability as a Precondition for the Financing of Sustainable Development in Emerging and Developing Countries

Summary

On 25 September 2015 the 2030 agenda for sustainable development was passed at the summit of the United Nations in New York. This agenda sees the *Sustainable Development Goals* (SDGs) replace the *Millennium Development Goals* (MDGs), which draw to a close in 2015. The new agenda follows a universal approach and will apply to developing, emerging and developed countries alike. It should also form the basis for a changed global partnership. The 17 Sustainable Development Goals link the principle of sustainability with economic, environmental and social development.

Financing plays a key role in the realisation of the objectives. In addition to trade, technology, the strengthening of local capacities and coherent international co-operation, financing is of paramount importance. Shortly before the passing of the 2030 agenda the financing of sustainable development was also discussed intensively within the scope of the 3rd UN Conference on Financing for Development. One of the goals of the Addis Ababa conference was to safeguard and improve the financing of sustainable development, particularly in developing countries. The necessary basis for this is a stable financial system, as a regional or global financial crisis could endanger the new development agenda. The final document places its priorities on the intensification of domestic resource mobilisation, the reliable disbursement of the funds for development co-operation and on tapping new resources of financing for developing countries. However, it does not address the role of financial stability in sufficient depth.

The choice of financing sources and instruments has a decisive influence on the stability of the financial system. During the global economic and financial crisis there was also a close interrelation between the financing structure and the effects of the crisis on the real sector. With the implementation of the 2030 agenda for sustainable development the question is raised as to whether the use of supplementary and new sources of financing fundamentally alters the financial structure in emerging and developing countries and what effects on financial stability are to be anticipated. This depends primarily on the financing conditions of a country. Secondly, the structure of the financial system plays a role because the size and breadth of the financial system and the role of cross-border financing determine the ability of the financial system to withstand systemic shocks. Thirdly, financing in order to achieve specific sustainable development goals can lead to new systemic risks. Its specific risk and financing profile makes the energy sector an example of this.

The risks to financial stability always need to be taken into account in the financing of investments in order to achieve the new sustainable development goals. On the one hand, the emerging and developing countries need to improve on managing financial complexity. On the other hand, more stringent international financial market regulation and more intensive co-ordination are required. This would enable the risks to financial stability to be contained and not used as an excuse for postponing investment in sustainable development.

Financing conditions in emerging and developing countries: the post-crisis situation

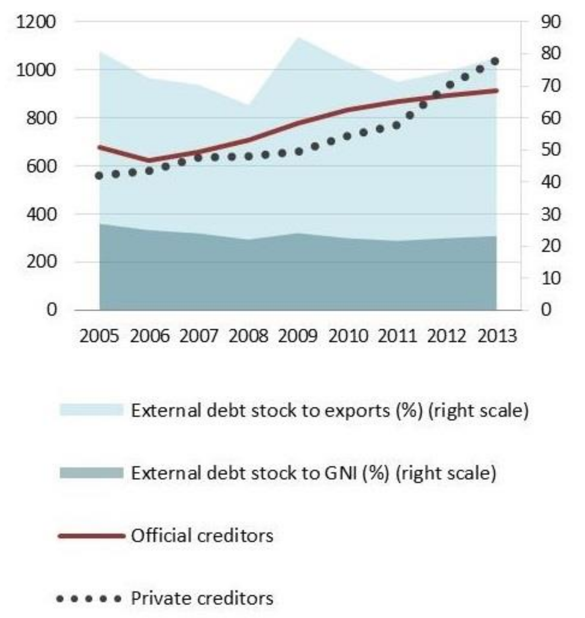
Over the course of the past three decades there has been a marked shift in the global landscape of development financing. The most evident change came as a consequence of the strong increase in private capital flows in middle-income countries. The changes in composition and the overall volume of finance flows have led to the establishment of two central characteristics in the structure of development financing: low-income countries are dependent on funds from official development co-operation, and middle-income countries are reliant on private flows of capital.

Prior to the global financial and economic crisis of 2008 the low interest rates prevailing in industrialised countries and the corresponding willingness of international investors to take risks led to an increase in finance flows in developing countries. As both exports and national income have increased in equal measure, long-term external debt has not changed significantly in the last ten years. Neither in relation to exports, nor to the income of the countries (cf. figure 1). However, the composition of the creditors has shifted in recent years to the extent that the external debt of developing countries is now financed to a larger degree by private creditors than public creditors. This new creditor composition brings with it new risks. If the outlook for economic development deteriorates and interest rates and long-term yields rise in industrial countries in the coming years, then private creditors will prove less lenient with regard to debt restructuring and the adjustment of terms of repayment than public creditors.

After the crisis, the renewed appetite for yields of investors in low-interest industrialised countries motivated these to extend their financial investments to developing and emerging countries. From the viewpoint of the developing countries, this is initially a move that enables them to utilise additional sources of financing, such as bonds and private equity capital. In addition to governments, companies could also benefit. They found private creditors to be willing buyers for their corporate bonds. The Bank for International Settlements (BIS) also addresses the effects of these unusually lax financing terms on the financial stability of emerging countries (cf. Chui, Fender, & Sushko, 2014). For example, companies in the major emerging countries issued bonds to the value of 375 billion US dollars in the period 2009–2012 alone. This represents more than a doubling of volume compared to 2005–2008.

If companies refinance themselves by issuing bonds in a foreign currency, specific refinancing and currency risks arise. Rising interest rates abroad and a devaluation of the local currency could see costs of financing rise strongly, in particular where no adequate assets or sources of income in foreign currencies are available.

Figure 1: Developing countries' long-term debt, 2005-2013 (US $bn, current)



Source: Authors, based on data from the World Bank, International Debt Statistics

Increasing risks for companies therefore also lead to potentially higher losses for the buyers of the corporate bonds. As in many cases local banks have also invested in corporate bonds, such a development has a weakening effect on their balance sheets. If the companies affected are forced to restructure their liquid assets and thereby reduce their deposits in banks, this also serves to weaken bank balance sheets. The current financing conditions of emerging countries in particular, both with regard to the new composition of creditors and currency and refinancing risks, present a significant potential danger for the financial stability of this group of countries.

The structure of the financial system and its influence on systemic risks

The global economic and financial crisis made it remarkably clear that the structure of the financial system, in other words the financial institutions, instruments and sources of financing, determines the vulnerability of a country and its economic development in the event of a crisis. In this respect the Sustainable Development Financing report of the UN Committee of Experts (2014) also stated that without a stable financial system the post-2015 development agenda could be at risk from a regional or global financial crisis. The stability of the domestic financial system is determined in particular by its level of development and the structure of its financial markets. Above all, the depth (measured in relation to GDP) and the range of the available instruments determine the liquidity and diversification options within the financial system. In comparison, financial markets in developing countries are only approximately half as deep and fluctuate more strongly than in industrialised countries.

The basic premise is that "thin" financial markets contain more systemic risks. This is due to the fact that their volatility as a whole is higher and the existing assets cannot be used as collateral. If only a few financing instruments are available, investors are more dependent upon available government bonds for liquidity management. As a result, large swathes of the corporate and banking sector are exposed to the risk of fragile public finances and subsequent political risks. A further decisive factor on the banking market is whether individual institutes hold dominant positions. In this case there is an increased risk that herding behaviour or the difficulties of individual financial intermediaries can risk the stability of the system as a whole.

In addition to domestic public and private financing sources (government bonds, corporate equity and bonds, bank loans), foreign private financing flows also play a key role in financial stability. These include cross-border bank loans, foreign direct and portfolio investments and remittances. Whilst foreign direct investment and remittances are regarded as relatively stable forms of financing, risks arising from cross-border capital flows are caused in particular by large volumes, which can lead to the overheating of the financial markets. Moreover, in the event of a shock a large share of short-term financing can lead to liquidity bottlenecks. If foreign banks are active in bank lending and these banks refinance on international wholesale markets, further refinancing risks may occur. Abruptly changed conditions may have direct consequences for domestic bank lending. Regulatory differences across borders can also lead to significant tensions in the event of a banking crisis. In summary, the systemic risk of the financial sector of a developing country always has an international component to it. Ensuring the consistency of financial market regulations across borders is therefore one of the most important tasks of both national and international financial market regulation. This is also referred to explicitly in the final document of the UN conference in Addis Ababa. This expressly calls for more international co-ordination and coherence in national rules of financial market regulation. The typical structural characteristics of the financial system in developing countries also present not insignificant risks for their financial stability. Will the realisation of the 2030 agenda for sustainable development see a change in financing structures as a result of additional financing from private and public sources? And what does this mean for financial stability?

One example: the seventh goal of sustainable development – energy

The goal to "ensure access to affordable, reliable, sustainable and modern energy for all" (SDG 7) calls for major investments in the energy sector, both with regard to renewable energies and opportunities to save energy. In this, it is possible to distinguish between two fundamental types of investment. For investments that secure access to cleaner energy or enable energy savings to be made, low volumes of financing are sufficient. These can also typically be adequately covered by local financing sources in emerging countries. This is subject to the existence of supportive framework conditions such as adequate market structures and financial market instruments for risk reduction. For investing in the production of renewable energy and infrastructure in general it is characteristic to have a high requirement of long-term financing *ex ante,* whilst the cash flows from the projects are realised *ex post*. In developing and emerging countries in particular the risk structure of the projects requires a high equity capital contribution of up to 40%. The long term also bears higher risks concerning political and economic instability. Long-term bank loans or bonds are not typically available in emerging and developing countries. Energy sector and infrastructure projects typically require financing over a 20-year period. If the financial market of the developing country only provides financing via bank loans or bonds for a maximum of 6–8 years, this means that the financing of the project is exposed to major refinancing risks. Foreign investors looking to finance equity stakes also have to deal with the fact that active foreign exchange futures markets only exist for the major currencies. This means that the appropriate hedging of currency risks is scarcely possible (cf. IRENA, 2012).

The significance of public financing mechanisms is therefore more likely to increase, not least in countries with an uncertain investment environment. To enable energy projects access to financing and develop private sources of financing a form of public financial development co-operation is required that makes it possible to render returns and risk structures of the projects attractive for private lenders, for example via a system of guarantees or the structuring of an investment fund. However, the lack of projects in a coherent and trustworthy legal framework represents a major obstacle to guiding funding to sustainable energy projects. Public funds will also be required for the development of bankable projects. Ultimately, the successful realisation of the projects will be dependent to a considerable extent on the targeted use of public funds for the mobilisation of private investment.

The involvement of private and public investors in sustainable energy and infrastructure projects means that there is an essential need to assess possible risks to financial stability. The high investment requirement may lead to national banks and investors in emerging and developing countries focusing their investments in specific areas, also as a result of the lack of suitable alternatives. Such a concentration on the bank balance sheets results in financial stability risks for the countries. One current example is the development in the field of infrastructure investment in India. The Governor of the Indian Central Bank warns against covering the high investment requirement at the expense of financial stability. Too many banks have allowed their investments and therefore associated risks to grow too strongly in this area (cf. Reuters, 2015).

Summary and recommendations

The implementation of the sustainable development goals calls for the development of additional sources of financing for developing countries, including via their national financing systems. In the process, the financing of resource-saving investments, for example in the energy sector, can bring with it not inconsiderable risks for the stability of the financial systems in emerging and developing countries. The over-rapid expansion of local financial markets and the creation of one-sided investments bear significant risks where insufficiently-regulated financial systems are involved. However, these can be overcome via good management and should not serve as an excuse for postponing investment in sustainable development.

There is a requirement for action to be taken on two levels:

The emerging and developing countries need to manage the complexity better themselves: the national regulatory authorities need to analyse the current financing situation and the structure of the financial system carefully, correcting it where necessary. Secondly, institutions and policies for the monitoring and regulation of financial stability and systemic risks need to be created and reinforced at national level. Thirdly, covering the financing requirements for sustainable development needs to involve a suitable combination of various public and private sources and taking account of the implications for financial stability.

Better international financial market regulation and co-ordination: The consistency of financial market regulation across borders is a key step in limiting systemic risks and can reduce dangerous contamination and transfer effects. In particular, joint supervisory bodies for systemically important financial institutions and standardised mechanisms for the resolution of financial institutions are key components. In addition, anti-cyclical buffers need to be created to increase resilience in the event of crises. This requires more intensive co-ordination of the international institutions and regulatory authorities involved. Particular risks to financial stability arising from the financing of resource-saving infrastructure investments should be included in the assessment of systemic risks and framework conditions created for their monitoring.

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With financial support from the Federal Ministry for Economic Cooperation and Development (BMZ)

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ISSN 1615-5483