

Eighth KfW International Financial Sector Symposium

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Session 5: Preserving Access to Finance - Enhancing Development Finance Effectiveness¹

Summary prepared by Rainer Hartel based on the keynote speech of Vinod Thomas, Senior Vice-President Independent Evaluation Group, World Bank, and the subsequent discussion.

Session 5 was composed of the following experts:

Keynote Speaker:

Vinod Thomas Director General and Senior Vice President Independent Evaluation Group, World Bank

Panellists:

Robert Mbugua Director, Standard Bank of South Africa, and Chair, Financial Sector Taskforce of the Africa Investment Climate Facility

Manuel Malaret Director Small, Medium and Microenterprises, Corporacion Andina de Formento

Bob Christen Director, Financial Services for the Poor, Bill & Melinda Gates Foundation

Doris Köhn Senior Vice President Europe, Middle East and North Africa, KfW Entwicklungsbank

Moderation:

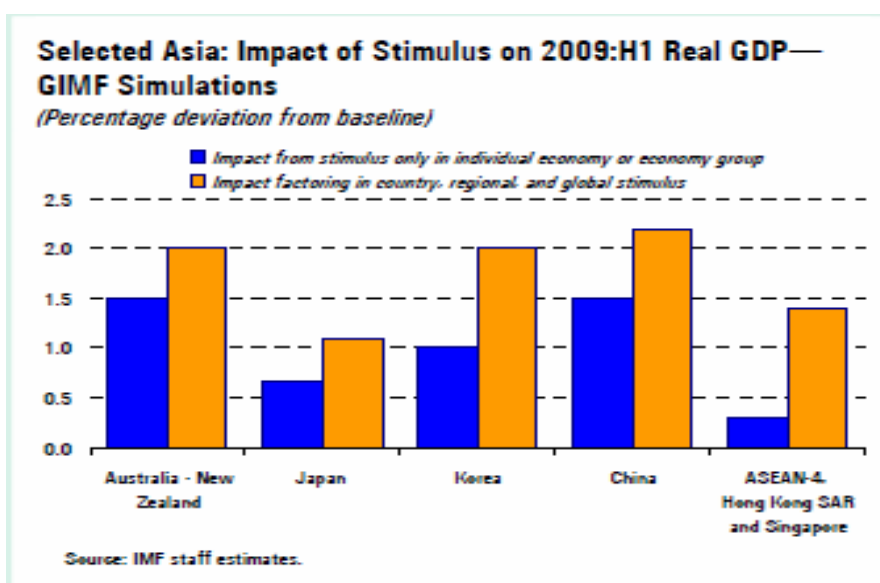
Eva Terberger Professor, University of Mannheim, First Vice President KfW Evaluation Department

Global Response to the Crisis- An unprecedented fiscal stimulus package

Take Away 1. This crisis response adopted the reverse approach used to combat previous crises. Focus on macroeconomic stability, fiscal prudence and deregulation was abandoned and massive fiscal and monetary expansion and tightening regulation of financial sectors were used instead.

The crisis response includes advanced, middle income and developing countries representing 5% of World GDP in 2009, or USD 3 trillion and as such the largest fiscal expansion in history. Whether this has led to resurgence of the global economy, is yet to be seen. The IMF estimates that some Asian countries will benefit from a 2% GDP growth impact of the stimulus package.

Chart 1:

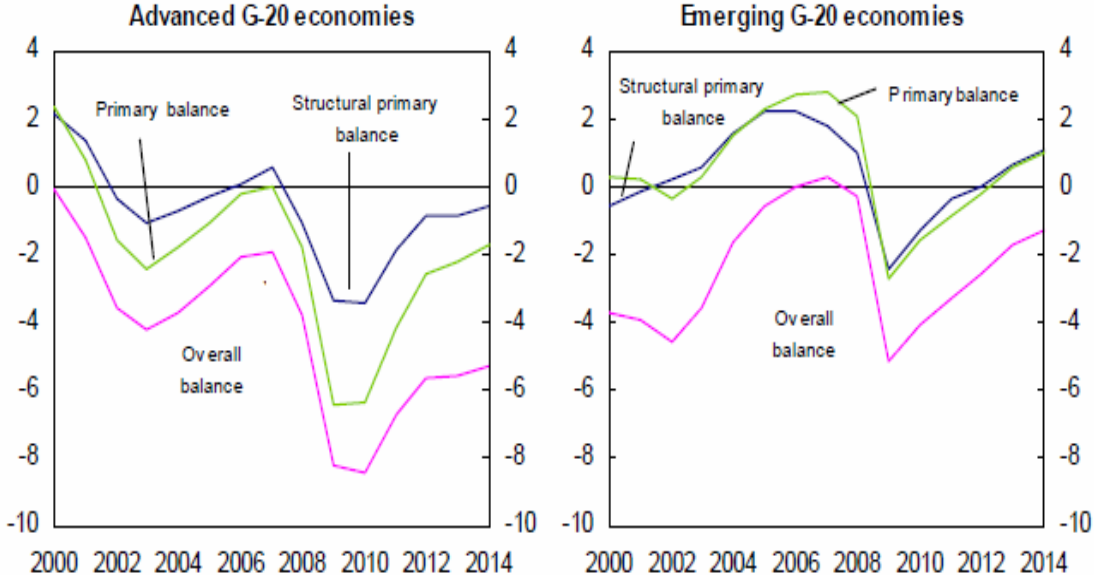


¹ For details see also keynote presentation of Vinod Thomas

While the focus in previous crises in Latin America or Asia was on fiscal tightening, macro-economic stability, and deregulation, the crisis response this time focused on a reverse approach through massive expansionary fiscal and monetary policies and tightening financial regulation.

The increase in the fiscal deficit has been dramatic and unprecedented. For 2009 and 2010, the G20 countries are looking at an increase in the fiscal deficit to 79% of GDP. Even emerging countries within the G20 witnessed striking increases in their fiscal deficits.

Chart 2:



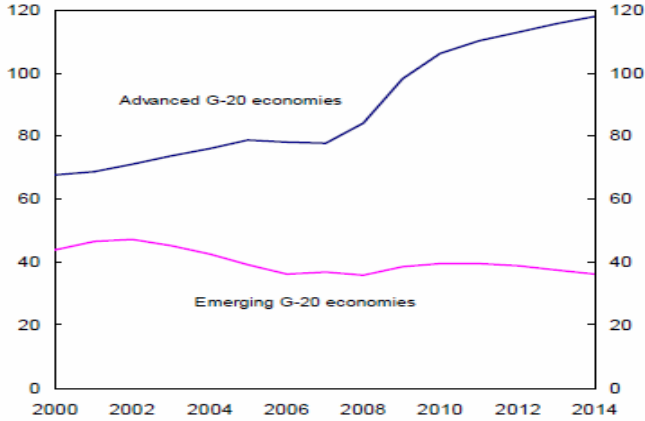
Source: IMF World Economic Outlook, October 2009

Take Away 2: The massive fiscal expansion was necessary but raises questions as to the quality of spending and fiscal sustainability. There is an urgent need to focus on the quality of spending to avoid a more severe crisis in the future. This has gained so far less attention compared with earlier crises.

The dramatic fiscal expansion requires attention to the quality of spending as well as the kind of tax reductions that have been put in place. Associated with the fiscal expansion are dramatic increases in public debt estimated by the IMF to increase by nearly 50% of their current debt to GDP ratios in advanced G20 countries within the next five years. This raises the question whether this spending makes sense, and whether this will not be the source of a second crisis.

Chart 3:

G-20 Countries: General Government Debt Ratios, 2000–14
(In percent of GDP)



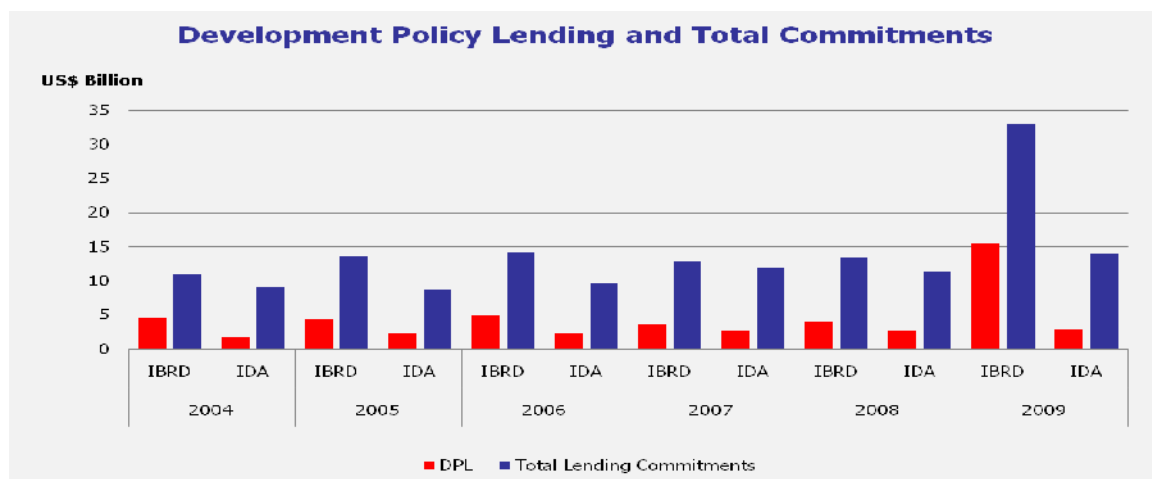
Source: IMF World Economic Outlook Database October 2009,

Given the extent and the nature of this crisis compared to previous crises, there is wide agreement that fiscal and monetary expansion made sense and may have with the rebound staved off a more disastrous picture. To stave off another more severe crisis the proper use of the fiscal deficit and the public spending will be critical. However, this point is getting less attention today partly because of the complexity of the current crisis.

Development Finance Institutions response to the Crisis

Across the world, whether it is the G20 expansionary policies, bilateral official development assistance, multilateral banks including the World Bank Group and the regional development banks have witnessed 2009 as the year with the highest lending in history. As for the World Bank (IBRD) there has been an increase of commitments to nearly USD 33 billion from USD 13.5 billion in 2008. Within this there has been a significant increase of Development Policy Loans (DPL), the instrument of choice for middle income countries that provide support for the aggregate economy, including budget and spending across the board. This huge increase in official spending is again to be scrutinised in its composition and impact.

Chart 4:



Source: World Bank Annual Report 2009

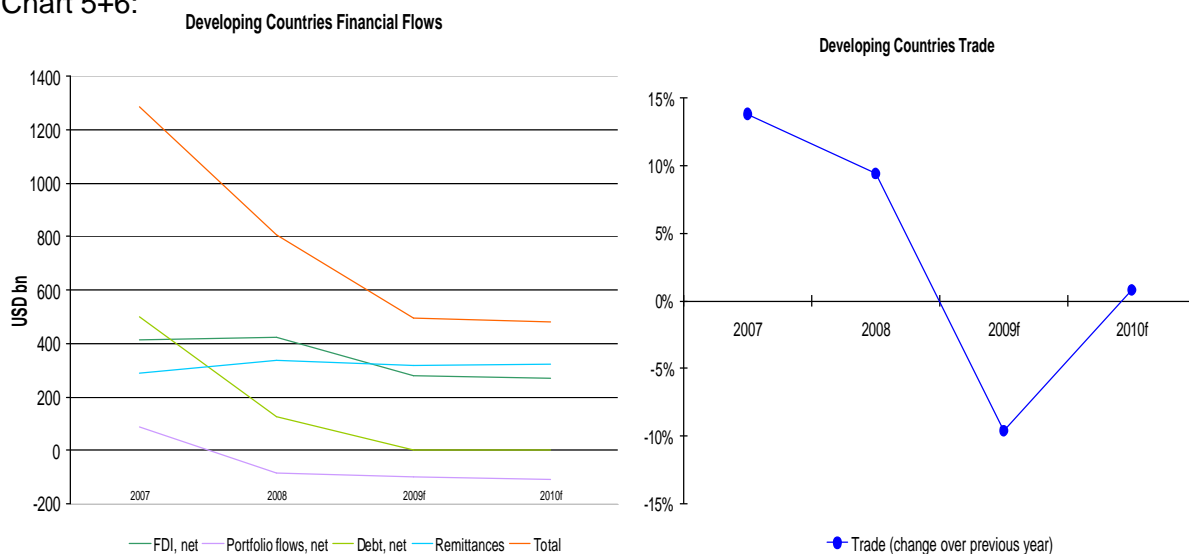
With the increasing volume of development financing, there is a high premium on effectiveness because it will translate into the countries' debt burden. In addition and contrary to earlier crises, there is a reduced focus on conditionality which has been an instrument to ensure quality. Whether conditionality worked well and whether its process was too complex is a point of controversial debate. In many instances the countries viewed conditionality as undesirable. However what measure of quality will replace conditionality and ensure that the beneficiaries understand the fiscal response and its adequacy to generate growth and the desired distribution. Improved monitoring, evaluation, and results frameworks operated on a country level by the policy makers may be an appropriate measure to fill this gap.

Take Away 3: The massive expansion of DFI commitments and DPL in particular was necessary but raises questions as to the quality of spending. With the relaxing of conditionality this has gained so far less attention compared with earlier crises. Appropriate measures of quality are needed.

Action to support crisis resilience and development effectiveness

The financing flow of private capital to low income countries fell from USD 1,2 trillion (2007) to USD 360 billion (2009) affecting the ability of these countries in meeting the core functions of a state (education, health and social safety nets). Fiscal stimulus and financing from external sources are vital to bridge the financing gap. The chart below illustrates the breakdown of the various sources. While remittances have held up until 2009, income and employment is now declining and remittances would also decline as a result. The importance of the specific flows differs by country, be it remittances in El Salvador or debt in Brazil or trade in Korea.

Chart 5+6:



Sources: IMF World Economic Outlook Database October 2009, World Bank Global Development Finance 2009; Migration and Development Brief; forecast

Countries more integrated into the global economy suffered the biggest decline in growth as a result from the global crisis. This might suggest that being more isolated from the global economy makes sense. However there is strong evidence that countries that are more integrated into the global economy are recovering the fastest. This finding, which also emerges from previous crises gives a sense of realism that for regeneration of growth the domestic economy is extremely important while the external economy is critical. Especially for large countries, a strong domestic economy is the key driver of growth. Both China and India are expected to register very strong rebounds over 2009 and 2010 like China 8,4% (2009) and 8,7% (2010) and India 7% (2009) and 7,7% (2010). However trade remains very important for growth especially for the smaller economies. As for trade, the trade finance gap caused by the ongoing crisis in developing countries is huge estimated of up USD300 billion. This needs to be addressed.

Financial flows are important but the flows to regenerate growth both through external and the domestic activity, especially in the larger economies, would be the critical test whether the financing of deficits is accompanied by the desired growth and distribution.

Since the high inflow of official and public resources is unlikely on a sustainable basis there is a need for the private sector to step in and pick up the growth momentum. Regeneration of growth through the private sector needs to reflect proper focus on the poorer segments of the population.

Take Away 4: Private financing flows to and trade of developing countries have collapsed and adversely affected countries' ability to meet its core functions. As continued public stimulus is not sustainable the private sector needs to step in for the turnaround.

Microfinance impact on poverty. Among the many areas of private sector involvement is microfinance. Partnerships and the actions taken especially to forge microfinance could be more critical especially during a crisis. Individual efforts are great, but well coordinated partnerships constitute a source of synergy as opposed to duplication. The impact of microfinance and the combined effect of multilateral development organizations is currently being analyzed by the evaluation cooperation group. So far positive impacts have been evidenced on the intermediary level but it remains difficult to measure final impact on employment and poverty. It is important to differentiate whether evidence was not found or whether there was no impact.

Take Away 5. Microfinance has been serving SMEs and poor households, but recent trend towards greater profitability and commercialization have put MFIs in a more vulnerable position.

The poverty impact of the crisis needs to be recognized and directly targeted. Some additional 90 million people are being pushed into extreme poverty as a result of the crisis on top of up to 155 million adversely affected by the global food and fuel crisis. Slow recovery means unemployment.

It will be a sustained problem for developed and developing countries. The gap between the world's production capacity and actual production is expected to remain large — about 6 percentage points of GDP for developing countries. The higher borrowing costs and weakened financial system will likely reduce the long run potential output of developing countries by as much as 4 percent of their GDP. Remittances to the poorest countries are anticipated to fall between 5 and 7% in 2009, recovering only modestly in 2010.

If not addressed early on some of the social losses are irreversible, whether expressed by hunger, poor education or health. *Historically, the tendency has been to deal with the financial crisis immediately and with the poverty crisis about two years later. There are huge costs to that approach because of the irreversibility.* Not addressing the losses for the poor in the earliest stages have severe long term consequences. Growth itself depends on addressing the distribution and the poverty issues upfront and not later on.

Take Away 6: Slow recovery and unemployment will be a sustained problem. Growth itself depends on addressing distribution and poverty issues. Not addressing losses for the poor in an early stage has severe long term consequences.

Social spending needs to be protected during the crisis to distribute benefits and to support growth. The large body of World Bank evaluations points to social protection programs with conditional cash transfers as an adequate instrument to generate growth and addressing poverty through transfers and conditions on kids going to school or going to the clinics. This nexus of growth and distribution impact in a crisis period is a very good case for social protection programs. Other social expenditure programs for example in Indonesia and China provide rich experience for comparing the combined use of employment and social safety net policies.

Take Away 7: Independent evaluations point to social protection programs with conditional cash transfers as an adequate instrument to generate growth and addressing poverty not just through transfers but also through conditions on kids going to school or going to the clinics. This effectively combines economic growth and distribution impacts.

<p>Expanding Social Spending Programs as a crisis response- Examples</p> <p>Brazil Bolsa Familia Food crisis – focused on inflation adjustments in benefits Financial crisis – increased coverage by 1.3 million households; raised eligibility to cover inflation Adjusted rural/urban balance in coverage to respond to crisis impact</p> <p>Mexico Oportunidades Increased benefits to compensate fuel and price increases Set minimum number of beneficiary requirements rather than caps on number of beneficiaries Strengthened effort to link with other programs, e.g. employment programs</p> <p>Colombia: Familias en Accion, Red Juntos - Expanded coverage</p> <p>El Salvador: Red Solidaria - Expedited program roll-out; raised benefit levels</p> <p>Chile: Chile Solidario, Subsidio Unico Familiar – Increased benefit to existing beneficiaries</p> <p>Indonesia: Mixing social protection and livelihood approaches</p>

Source: World Bank Independent Evaluation Group; O'Keefe (2009)

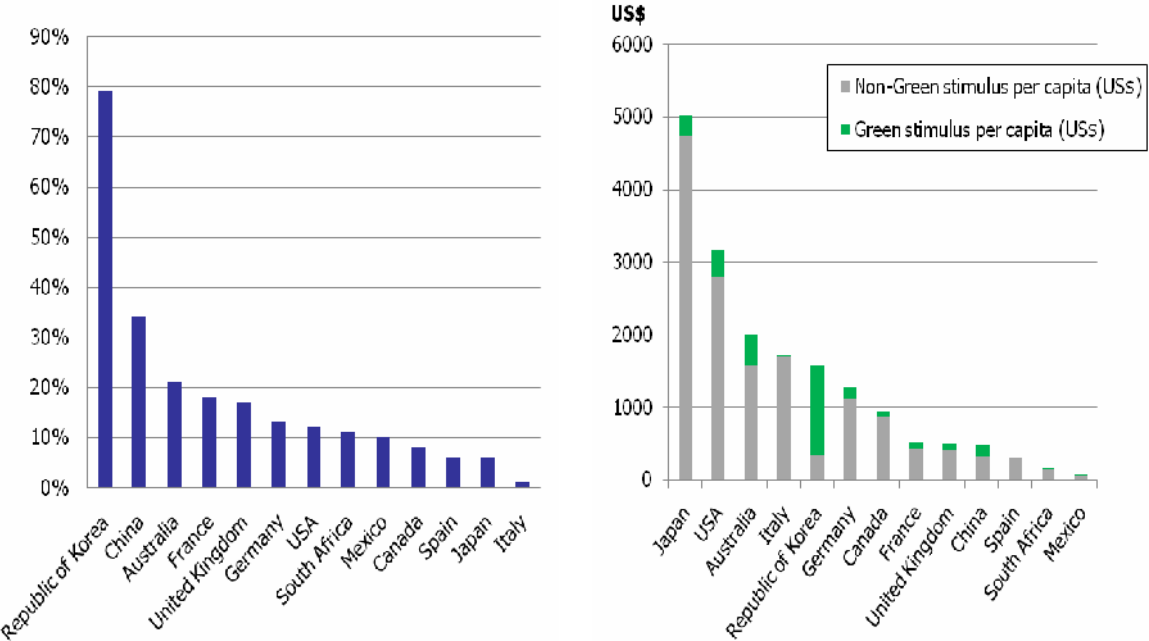
In a financial crisis environment has always been the last thing to worry about. Also this crisis has diluted appropriate attention to climate change and the environment. Delays in addressing the threat of global warming will substantially increase the costs for mitigation and adaptation.

To illustrate the urgency a group of independent researchers has estimated that the greenhouse gases of 2008 were forty percent higher than in 1990. If that trend continues for the next 20 years, even with a constant 2008 base, a 2 percent increase of global warming would be the result. This is the point where we enter an ice-free planet. At a current 385 particles per million (ppm) of Co2, reaching 450 ppm means an ice-free world. If not handled well, the climate crisis would trigger a crisis that will overwhelm everything else.

Addressing climate change is currently extremely challenging because the financial crisis has to be addressed first to provide the source of funding to address climate change. As mentioned above the impact on the poor will also need to be integrated in the immediate crisis response. However the ongoing crisis may be an opportunity to shift gears toward “green” investments that will have an impact for the next 20 years. The “green fund” share of economic stimulus on the left hand side illustrates that Korea made an extraordinary effort of spending nearly 80 % in green investments followed by China, Australia, France, the UK and Germany. It is to be watched how investment patterns are changing as a result of the stimulus.

Chart 6+7:

Green Fund share of Economic Stimulus Stimulus Package per capita and Green Component



Source: HSBC Global Research, UNEP Global Green New Deal: An Update for the G20 Pittsburgh Summit, Sep. 2009

Too early to talk about a recovery. Financial flows, especially to the lower income countries will remain critical midway through the crisis. On monetary policy some middle income countries may exit from their partly extraordinary interventions. The fiscal impact is far too small as estimates of the 3rd quarter 2009 suggest. There are huge country variations and no evidence of a recovery. Fiscal expansion has to remain high. However, the shift towards a greater role for governments needs to be balanced with efforts to reinvigorate the private sector, without which estimates on the recovery are unlikely to materialize.

Regarding the quality of public stimulus it is imperative to focus spending on the highest returns. There is evidence from Japan and other advanced countries that infrastructure does not automatically mean generating growth. It depends on how spending is done. Social spending can be highly income generating and justify the high fiscal deficits. This means that social safety nets are to be strengthened immediately. Environment and Climate change have to be an integral part of the crisis response to provide for a quality impact in the future.

Take Away 8. The crisis is far from over and fiscal expansion has to remain high. However the public efforts need to emphasize the need to reinvigorate the private sector, strengthen equitable growth through social spending and incorporating investments supporting mitigation and adaptation to climate change.

Discussion

In a crisis quantity of finance is identical to quality. The first priority is to regain quantity. Even the fiscal stimulus is spent badly, there is growth. This can be misleading if poor quality spending continues. Once capacity is reached, sustained growth is essential. Recuperation of

growth is a misleading indicator for sustained growth. If quality of spending is lacking, build-up of the fiscal deficit and debt is a longer term phenomenon which could be the basis for another crisis. It would be a mistake to prioritize financing flows first and address quality later.

In a crisis speed is quality. DFIs need to move quickly providing liquidity in the first round and subsequently equity and similar instruments. In a crisis good investors with a long term view need to replace those who had only the quick return in mind. Although high uncertainty may deter a quick response there is a very high cost of doing nothing or responding too late. The cost of doing nothing may exceed that of taking decisions and risks under high uncertainty. It is agreed that speed is critical, but there is a trade off with quality. The experience of the World Bank Group is that there is a trade off with quantity and speed on the one side and quality on the other since staff resources are constrained by a certain budget. Spreading staff resources over a rapidly increasing loan portfolio both in number and amount requires quality to catch up soon.

For improving market confidence was it not enough for the G20 to announce the crisis response? Many countries, especially middle income countries, were in a position to respond because there was a reasonable fiscal management. Compared to previous crises, there was more coordination. Presenting aggregate numbers for G20 and others had a signalling effect on their ability as a group. The fact that a huge amount was on the table boosted confidence.

Did trade finance collapse because of reduced demand in trade of developing countries? There are both demand and supply side effects that cannot be entirely separated. It is however evident that some of the trade of developing countries has been held back because of the collapse of trade finance during the crisis.

We can have a bigger impact by working together. Collaboration of IFIs during the crisis such as the IFI action plan or the Vienna initiatives or the MEF produced a bigger voice and bigger impact. Working together has two major effects. One is the signalling effect to the world. Together we are stronger and able carry a signal, which is a quality in itself. The other one is building on each others strength and creating synergy. On both the crisis has helped.

Is it sensible linking social protection (conditional cash transfer) programs with pension and capital market reform? There are different crisis buffers and even in poor countries some pension system may be in place. However in most developing countries old age provision is not available as a financial service. As a crisis buffer access to proper pension systems, may constitute a large benefit not just for the individuals but also for the market itself. Conditional cash transfers got highest marks by evaluating standards in producing results. Beyond that linking conditional cash transfers to the banking system and making that sustainable, by linking it to pensions and other means to provide safety nets and social security is a big point. The point of linking the conditional cash transfers with all its strength to capital markets and to markets in general is a great point of this session.

There is early anecdotal evidence from a project in Mexico that conditional cash transfers may be useful by moving the transaction point out to the village as opposed of access remaining confined to towns or larger cities where the cash transfers are distributed. This move to the village might have a local economic effect, which might improve rural livelihood.

The crisis has highlighted structural weaknesses of developing countries that need to be addressed over the long term. It is notable that Africa was relatively isolated from the crisis and thus partly benefited from the loss of market confidence in other regions of the world. However because of unfavourable investment climate, including weak rule and enforcement of law, corruption, and counterfeiting piracy are widespread deterrents for potential investors. Good Governance especially fair access to justice is essential to establish confidence for the right private investors and a level playing field in the market. The World Economic Forum and PwC identified access to justice being the most important investor issue to be addressed in Africa.

Private Sector involvement in service delivery (economic and social infrastructure, agriculture) triggers innovation. IFIs and governments should work with the private sector across the whole range of PPP models to get a better value from money. There is a strong need for attracting responsible private sector investors.

There was debate on whether the crisis necessitates extraordinary efforts for preserving existing well run financial institutions that got in trouble or whether continuation of a long term strategy to develop market outreach for the poor is more sensible. The discussion also pointed out that microfinance witnessed a certain hype before the crisis, which led to mission drift and excessive supply in some markets, for example in Bosnia, which has undermined the performance of microfinance irrespective of the crisis. In general the DFIs' view was that special well coordinated efforts are needed to preserve access to finance. A philanthropic organization pointed out that targeting access to finance to a clientele earning less than 2 dollars a day requires a long term approach. Collaboration with well established banks and service networks need to ensure that deposit, payment and remittance services are available to this low-income segment in urban and increasingly rural areas as well. In this long term effort cyclical shocks are minimal because of the low integration of this segment in the financial and real sectors. Also the mobilization of local currency deposits enhances significantly the crisis resilience of the deposit taking banks involved, whereas microcredit institutions witness the full blow of the crisis.