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Economic Justification for a Bank of the South

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Economic Justification for a Bank of the South

Introduction

1. The idea of a Bank of the South has figured intermittently in different developing country forums ever since it was proposed in the early 1980s by the G-77 in the context of "South-South financial cooperation". Despite favourable technical studies on its feasibility,[1] the proposal failed to take off. The main reason appears to have been capital scarcity in developing countries, many of which were passing through a severe debt crisis during the eighties. The reticence of all-powerful multilateral financial institutions such as the IMF towards the proposal may have also contributed to the subdued response from developing countries[2]. The proposal resurfaced at G-77's South Summit held in Havana in 2000 via an initiative of the G-77 Chamber of Commerce and Industry to establish a G-77 Trade and Development Bank. However, the proposal was once again a victim of bad timing, as at the time, many developing countries in both Asia and South America, were in the throes of a financial crisis. More recently, the suggestion for a South Bank was put forward by Venezuela during G-15's Caracas Summit held in 2004, as a South-South Cooperation proposal. Following the Summit, the issue was referred to the Panel of External Consultants for evaluation. The Panel concluded that the proposal was not likely to succeed as *"…similar initiatives in the past did not get off the ground for want of political and financial support…"*[3]

2. Several recent developments have, however, taken place in the world of global finance, which perhaps warrant a new look at the concept. In the first place, a significant change has occurred in the relationship between developing countries and multilateral financial institutions such as the IMF and the World Bank. Secondly, developing countries' attitudes towards private foreign capital inflows from the North have considerably hardened following financial crises in East Asia and Latin America around the turn of the century. At the same time, there has been a sharp rise in the foreign exchange holdings of a large number of developing countries, reflective of a 'savings glut', which offers an unprecedented opportunity for developing countries to take control of their own development finance needs.

3. In the present paper, an attempt has been made, devoid of any ideological or political considerations, to make out a case for creating a Bank of the South. Using recent economic data and statistics from G-15 countries[4], it will be shown that the Group faces an annual funding 'gap' of around $480 billion against its development finance needs. The paper goes on to show that there has been a general decline in development finance from multilateral financial institutions as well as inadequate capital flows from regional development banks. Many G-15 countries have also tightened regulations on private capital inflows from the North following financial crises triggered off by the sudden withdrawal of such capital. Given the underdevelopment of bond and equity markets in most developing countries, the paper concludes that using the fast rising savings of developing countries to establish a Bank of the South offers a new window of opportunity to G-15 countries to bridge their development finance gap.

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[1] Prepared by the International Centre for Public Enterprises in Developing Countries (Ljubljana) on behalf of the G-77.

[2] Note prepared by UNCTAD in response to a G-15 request for an updated feasibility report on the creation of a South Bank, 4 October 2004.

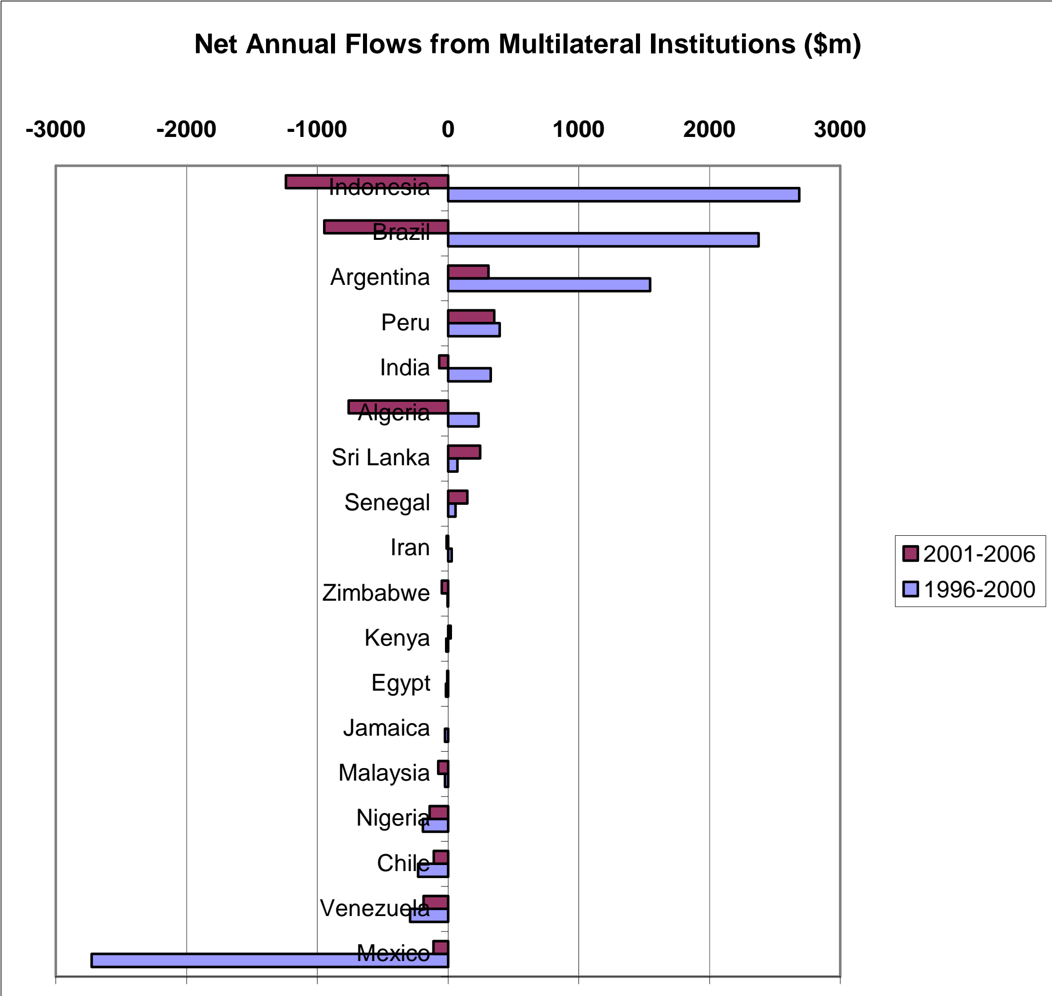
[3] Paragraph 46, Report of the Panel of External Consultants on the Examination of the Challenges facing the G-15 and Evaluation of its Projects for South-South Cooperation, May 2005.

[4] We are confident that the analysis can be replicated for the entire developing world, with similar conclusions.

The declining role of multilateral finance

4. Over the decades, developing countries have looked to multilateral institutions to help them overcome their 'capital constraint' i.e. to finance the gap between domestic savings and investment needs. However, in sharp contrast to its heydays in the 1990s, the flow of capital from institutions like the World Bank and the IMF to developing countries has witnessed a marked decline during the present decade. There are several reasons for this development. In the case of the IMF, there is a crisis of credibility, following incidents when policy advice given to countries facing financial crises allegedly exacerbated the problem instead of solving it. Many countries (including some G-15 countries) have therefore chosen to break free from IMF by repaying their loans in full, ahead of time and are reluctant to take on any further financial assistance from the organization.[5] World Bank loaning to developing countries has also fallen owing, *inter alia*, to a growing reluctance to accept the elaborate pre-conditions often attached to World Bank loans. The Bank's structural adjustment programmes have, in a number of cases, allegedly resulted in serious negative consequences to developing countries in the form of a rise in unemployment and other 'social costs'.

Figure 1



[5] The International Herald Tribune has recently reported that so many countries have repaid IMF loans that the institution, finding its interest income falling sharply, is looking at alternative options to meet its overhead expenses, including selling its stock of gold bullion. (IHT, 23 May 2007).

5. Annex Table 1 compares the net capital flows from multilateral institutions to G-15 countries during the first half of the present decade with the flows in the latter half of the1990s. It shows that between 1996-2000, G-15 countries as a group were net *recipients* of US$ 4.2 billion worth of development assistance every year from these organizations. By contrast, between 2001-2005, the G-15 actually experienced an annual net *outflow* of US $2.6 billion to the multilateral institutions. The sharpest reversals have occurred in the case of Indonesia and Brazil, where the large inflows of the 1990s have been turned into large outflows during the present decade. Just two G-15 countries, viz. Senegal and Sri Lanka, have witnessed a significant rise in net inflows from these institutions. Figure 1 is a diagrammatic presentation of Annex Table 1.

The limited capacities of Regional Development Banks

6. The idea of a Bank of the South has often been criticized on the grounds that it would be merely duplicating the role of existing institutions like regional development banks[6]. The report of the Panel of External Consultants for the G-15 also stated that "(Instead of establishing a new development finance institution)...*countries should rely on…the existing regional banks such as the Asian Development Bank, African Development Bank, Inter-American Development Bank* …" In order to check the validity of this argument, the TSF looked at the quantum of financing that the regional banks undertake in comparison to the actual development finance needs of G-15 countries.

7. Development finance needs of any country are difficult to estimate as a lot depends on the level of development that is being targeted. The task of estimation is also complicated by the absence of cross-country comparable data on different development variables. Typically, one has to rely on thumb-rules that have been formulated by development finance experts that display a fair degree of reliability without necessarily being perfectly accurate. The TSF has estimated the development finance requirements of the G-15 countries indirectly, by using a formulation prepared by World Bank economists for calculating infrastructure finance. This formulation states that low-income and middle-income countries need to spend annually, around 6.9% and 5.1% of their respective GDPs to fulfill their infrastructure finance needs[7]. Assuming that infrastructure requirements take up a third of all development expenditure, the TSF has estimated that the annual development financial needs of all 18 G-15 countries are of the magnitude of $640 billion. Details of the estimation are in Annex Table 2. The TSF has further estimated the availability of development finance of the magnitude of approximately $160 billion every year in the G-15 countries[8]. This leaves a massive annual gap of $480 billion for financing development activities in the G-15 countries.

8. What is the quantum of development financing that the regional development banks actually provide to G-15 countries? Table 1 below, shows the net flows from regional development banks to G-15 countries during 2005.

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[6] For a recent critique, see " Bank of the South: Political Driven Agenda Duplicates Existing Institutions", Vladimir Torres, *Focal Point*, Vol.6, No.3 , Canadian Foundation for the Americas, April, 2007.

[7] Fay, M. & T. Yepes, (2003), *Investing in infrastructure: what is needed from 2000 to 2010?* World Bank Working Paper 3102.

[8] These estimates were arrived at by adding G-15 governments' outlays on all economic and social sectors plus private investment (including FDI) in infrastructure between 2003-2005 and averaging.

Table 1

Net Financial Flows from Regional Banks (2005) ($m)

Country	Net Flows
Algeria	-211.6
Argentina	60.9
Brazil	722.8
Chile	-31.2
Egypt	-91.9
India	419.5
Indonesia	513.6
Iran	0.0
Jamaica	-40.3
Kenya	13.3
Malaysia	-39.4
Mexico	346.4
Nigeria	-73.6
Peru	258.8
Senegal	19.4
Sri Lanka	166.1
Venezuela	-182.3
Zimababwe	0.0
G-15 Total	**1850.5 or $1.85bn.**

Source: TSF calculations using Global Development Finance, 2006 (World Bank) data

9. The table shows that against the estimated funding gap of $480 billion, net flows to G-15 countries from the regional development banks amounted to just $1.85 billion in 2005. In fact, gross loan approvals to *all* their member countries by the African Development Bank, the Asian Development Bank and the Inter-American Development Bank in 2006 were $3.4 billion, $7.4 billion and $ 5.4 billion respectively, amounting to a total of $16.2 billion for all three Banks. In other words, the funding capacity of the regional development banks is clearly inadequate for the development finance needs of G-15 countries and the argument that they can be substitutes for a Bank of the South appear to be grossly at variance with the actual financing needs of the developing world.

The diminishing importance of foreign private capital

10. Till recently, private foreign capital inflows led by foreign direct investment (FDI) from the developed countries, were regarded as the solution for all developing countries facing a shortage of capital for their development needs. Foreign investors were considered not only a source of capital but also of technology and new managerial and marketing skills and networks. Hence, foreign capital was welcomed and actively wooed by most developing countries, including the majority of G-15 countries. New evidence has, however emerged that clearly indicates that G-15 countries have, over time, become more selective and conservative towards private foreign investment.

11. The Heritage Foundation calculates every year the relative openness of economies that includes an index of " openness to foreign capital". A comparison of this index for 2007 with the index for 1995 shows that of the 18 G-15 countries, seven countries viz. Argentina, Indonesia, Malaysia, Mexico, Nigeria, Venezuela and Zimbabwe, have become *less open* to foreign capital. Nine other G-15 countries have maintained an unchanged policy towards foreign investment, and only two, Iran and Jamaica have actually become more open to

foreign capital[9]. Indeed, as Annex Table 3 indicates, between 1990-2000 all G-15 countries, with the sole exception of Egypt, experienced a rise in the share of FDI in their GDPs. However, between 2000-2005, seven G-15 countries saw a decline in the importance of foreign capital in their respective economies.

12. To a large extent, this caution with respect to foreign capital has emerged following the experience of financial shocks, triggered usually by the rapid flight of foreign capital originating in the developed world. Indeed, many of the G-15 economies that have become less open to foreign capital inflows have undergone financial crises where foreign capital 'flight' has played an exacerbating role. The tightening of controls on foreign capital in developing countries together with the higher risk ratings of many 'emerging' economies following financial crises, implies that private foreign capital inflows are a significantly less reliable source of development finance than they were, say in the 1990s.

Individually, G-15 countries lack capacity to tap international capital markets

13. What are the other potential sources that developing countries can look to for funds to fill the development finance gap? The relatively low rates of return on development projects imply that equity investment is not readily forthcoming for this sector. In the majority of developed countries, on the other hand, the bulk of development finance, especially infrastructure finance, is raised through debt instruments like bonds. Debt instruments are particularly suitable for generating development finance as their long-term maturity periods fit in well with the long gestation periods of development projects. In particular, institutional investors carrying long-term liabilities, such as insurance companies and pension funds, show a marked preference for investing in bonds.

Table 2
Capital raised through international debt instruments in selected countries
($Billions)

	Amount of debt outstanding in December 2006	Net issues in 2006
United States	4403.6	778.9
United Kingdom	2087	391.1
Germany	2607.6	203.8
France	1264.4	179.7
Brazil	111	0.3
South Korea	100.8	16.2
Russia	94.7	24.7
Mexico	93.6	2.3
Argentina	60.9	0.1
Malaysia	32.1	3
Venezuela	22.6	-3.3
India	19.8	9
Indonesia	18.4	4.2
Chile	10.9	-0.1
Peru	9.4	1.3

Source: Bank for International Settlements, Quarterly Review, March 2007.

[9] www.heritage.org/index/

Unfortunately, a market for international debt instruments does not exist for many G-15 countries. Even where it does, its ability to generate development finance is limited by its small size. As Table 2 above reveals, only nine G-15 countries are presently using debt instruments to access international capital markets. Apart from Brazil, Mexico and Argentina, the accumulated capital raised by the rest (as indicated by the amount of debt outstanding), is quite insignificant compared to their development finance needs.

Swelling G-15 surpluses could provide the solution to development finance

14. Against the backdrop of the huge developmental finance gap that G-15 countries face, and the absence of any signs that existing financial institutions or sources of finance (foreign private capital, debt markets) are in a position to bridge it in the near future, it is only appropriate that G-15 countries seriously explore the possibility of establishing a new institution like a Bank of the South. It is also an opportune time for conducting this exercise on account of two favourable developments that are strengthening the financial capabilities of G-15 countries. Firstly, the G-15 as a group is emerging as a big saver, with a substantial annual net surplus. Secondly, with a few exceptions, there has been a sharp surge in the foreign exchange reserves of most G-15 countries. By pooling part of these savings to create a new institution, the G-15 could meet the challenge of shortage of developmental finance that is seriously constraining the development of their economies.

15. Table 3 below shows the gap between savings and investment in different G-15 countries using data for the period 2003-05. It shows there are 9 surplus countries

Table 3

Gap between savings and capital formation in G-15 countries

Surplus Countries

	2003-2005 Annual Average (billions of current US $)		
	Gross National Savings	Gross Capital formation	Surplus
Venezuela	39.3	22.31	16.99
Malaysia	41.4	25.13	16.27
Algeria	40.5	26.56	13.94
Brazil	140.1	130.81	9.29
Indonesia	68.9	60.99	7.91
Iran	63	57.05	5.95
Argentina	34	29.43	4.57
Nigeria	20.8	16.89	3.91
Egypt	17.1	14.49	2.61
		Total	**81.44**

Deficit Countries

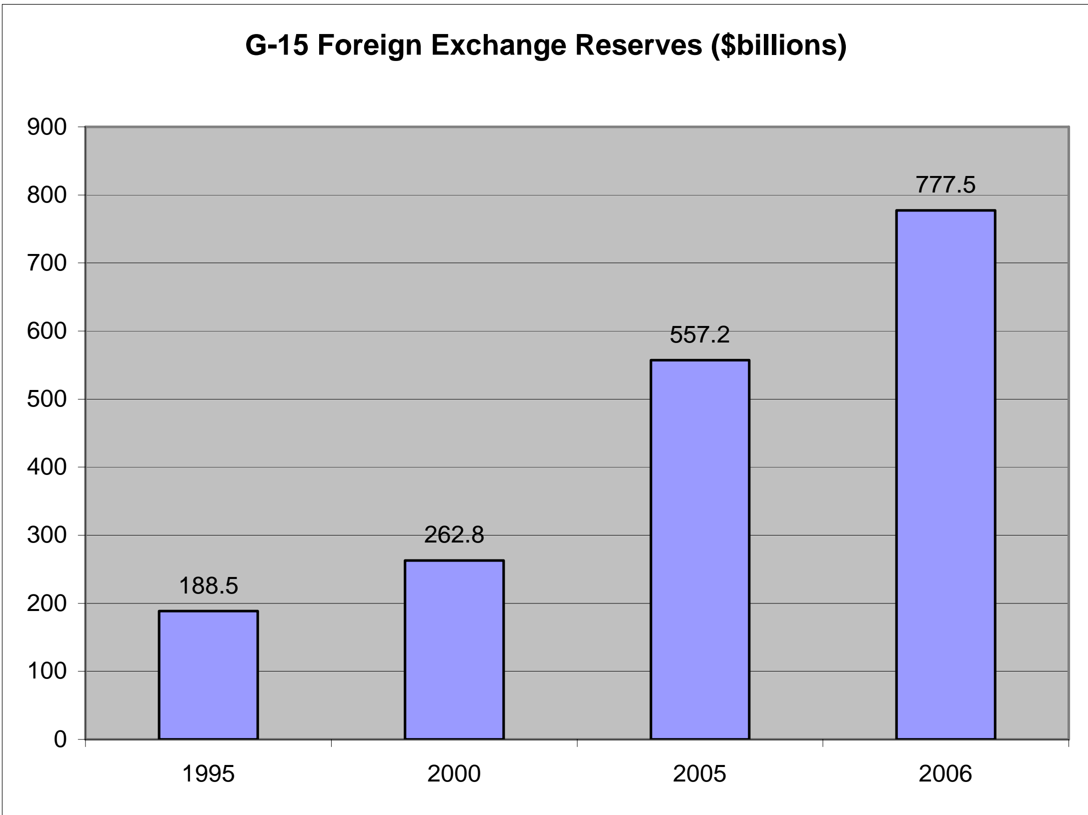
	2003-2005 Annual Average (billions of current US $)		
	Gross National Savings	Gross Capital formation	Surplus
Mexico	142.7	149.89	-7.19
Chile	16.7	20.99	-4.29
India	215.2	216.5	-1.3
Sri Lanka	4.2	5.06	-0.86
Jamaica*	1.8	2.61	-0.81
Kenya	2.3	2.9	-0.6
Senegal	1.2	1.68	-0.48
Zimbabwe	0.3	0.67	-0.37
Peru	13.1	13.16	-0.06
		Total	**-15.96**

Source: TSF calculations, using the World Bank's World Development Indicators, various years.

within the G-15, whose average annual savings exceed investment by an amount of $81.44 billion. The remaining nine countries have an average annual deficit amounting to $15.96 billion. On balance therefore, G-15 countries are currently generating surplus savings of around $65 billion every year.

16. Evidence of rising savings among G-15 countries is also available from the strong growth of foreign exchange reserves in most G-15 countries. Figure 2 below shows the level of G-15 countries' foreign exchange reserves at different periods of time over the past decade. The figure shows that reserves have tripled since 2000 and if the trend continues, are likely to approach $1 trillion by the end of 2007. The growth of foreign exchange reserves for individual G-15 countries can be seen in Annex Table 4.

Figure 2



17. It is generally believed that a significant portion of the foreign exchange reserves of developing countries is parked in low-yield safe havens such as United States treasury bonds. In addition to foreign exchange reserves, many G-15 countries also have huge stockpiles of savings lying in different sectors of the economy. Chile's privately managed pension funds alone are reported to have nearly $100 billion in assets[10]. While the maximum rate of interest on 30-year US treasury bonds is around 5% today, many developing countries may well be agreeable to guarantee a minimum rate of return of 16% on critical infrastructure projects. Thus, a substantial pool of funding is available with G-15 countries that could be invested in development projects that provide much higher yields. A Bank of the South is one way to intermediate the redeployment of G-15 savings from low yielding securities outside developing countries to high yielding projects within the developing world.

[10] Dow Jones Newswires, 1 June 2007, www.nasdaq.com

Conceptualizing a Bank of the South for the G-15

18. While it is premature to detail a possible structure for the Bank of the South at this stage, a few preliminary suggestions can be made. G-15 countries could agree to provide as a one-time contribution, an equal percentage of their growing foreign exchange reserves to the core capital of the Bank. Given that existing rules permit the participation of non-members in G-15 project activities, membership of the Bank of the South can be thrown open to all developing countries that may wish to join. Technical support for establishing the Bank can be sought from the Bank for International Settlements in Switzerland. The financing of development activities in G-15 countries need not be defined by the amount of the Bank's paid-up capital. Like other multilateral financial institutions, it should be able to shore up its funding capacity by accessing international capital markets. Typically, multilateral financial organizations (including the World Bank) leverage their superior credit ratings to obtain capital at low rates of interest, which in turn is loaned at slightly higher (but below market) rates. The difference in interest margins helps pay for the costs of running the organization. As a multi-regional body straddling three continents, the Bank of the South would be able to command greater credibility than individual G-15 countries and raise the necessary finance directly as well as by catalyzing private investments.

19. The Bank of the South would have three main functions: 1) It's main role would be to mobilize developing country savings to help bridge the development finance gap in member countries; 2) In addition to financing, the Bank would also provide technical assistance in identifying and preparing infrastructure and other development projects for implementation in member countries; and (3) Finally, the Bank would act to use the pool of funds at its disposal to protect member countries' currencies from speculative attacks, thereby insulate them from external financial shocks. In the discharge of the first two functions, the Bank of the South could use the European Investment Bank as a possible role model.

Concluding remarks

20. In view of the emerging changes in the global balance of financial power, several initiatives are already underway in different regions of the world to secure the economic interests of developing countries, independent of western financial resources. Recent examples include the agreement reached by the ASEAN + 3 countries to pool their financial reserves in case of a financial emergency and the conceptualization of an African Finance Corporation to bridge the gap in infrastructure finance on that continent. Thus, rather than viewing it as an emotive 'solidarity project' or duplicating the functions of any existing international financial institution, the Bank of the South needs to be seen as part of a larger ongoing process of financial integration among developing countries, whose other manifestations include the strengthening of South-South capital flows, growing trade between developing countries and a marked rise in South-South cross-border banking activities[11].

21. In the light of the foregoing considerations, the proposal for the establishment of a Bank of the South to deepen South-South cooperation should be revisited for a favourable consideration.

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[11] See Chapter 4, Global Development Finance, 2006, World Bank for further details on this trend.

ANNEXES

Annex Table 1

Average annual net inflows from multilateral institutions* ($m)

	1996-2000		2001-2005	
Algeria	235		-760	
Argentina	1546		309	
Brazil	2376		-947	
Chile	-229		-109	
Egypt	-16		-6	
India	326		-68	
Indonesia	2686		-1241	
Iran	29		-12	
Jamaica	-22		1	
Kenya	-14		21	
Malaysia	-22		-74	
Mexico	-2726		-112	
Nigeria	-192		-141	
Peru	394		353	
Senegal	57		149	
Sri Lanka	72		246	
Venezuela	-291		-188	
Zimababwe	-4		-49	
G-15	4205	**or$4.2bn.**	-2628	**or -$2.62bn.**

* Sum of flows from the World Bank, IMF, Regional Banks, IFC and other multilateral institutions

Source: TSF calculations based on Global Development Finance (IMF) data: gdf-online.

Annex Table 2

Annual Development Finance Needs of G-15 countries ($m)

	GDP(2005)	Infra structure Finance Needs*	Total Development Finance Needs**	
Algeria	102250	5215	15644	
Argentina	183190	9343	28028	
Brazil	796000	40596	121788	
Chile	115250	5878	17633	
Egypt	89400	4559	13678	
India	805710	55594	166782	
Indonesia	287220	14648	43945	
Iran	189780	9679	29036	
Jamaica	9570	488	1464	
Kenya	18730	1292	3877	
Malaysia	130330	6647	19940	
Mexico	768440	39190	117571	
Nigeria	98950	6828	20483	
Peru	79380	4048	12145	
Senegal	8240	569	1706	
Sri Lanka	23480	1197	3592	
Venezuela	140190	7150	21449	
Zimbabwe	3370	233	698	
G-15			**639460**	**or $640bn.**

*Calculated @ 6.9% of GDP for India, Kenya, Nigeria, Senegal and Zimbabwe & @ 5.1% for the rest

** calculated at 3 times as much as infrastructure finance requirements.

Annex Table 3

Inward FDI stock as a percentage of Gross Domestic Product

	1990	2000	2005
Algeria	2.5	6.4	8.1
Argentina	6.2	23.8	30.4
Brazil	8.5	17.1	25.4
Chile	30	61.1	64.6
Egypt	26.4	17.7	31
India	0.5	3.8	5.8
Indonesia	7.7	16.5	7.7
Iran	2.3	2.4	1.9
Jamaica	18.5	42	65.1
Kenya	7.8	8.9	5.8
Malaysia	23.4	58.4	36.5
Mexico	8.5	16.7	27.3
Nigeria	26.3	48.6	35.1
Peru	4.5	20.8	20.2
Senegal	4.5	19	13.5
Sri Lanka	8.5	9.8	10.4
Venezuela	8	29.3	34.8
Zimbabwe	3.2	22	30.8

Source: TSF calculations based on UNCTAD's World Investment Report data (various years)

Annex Table 4

Rising Foreign Exchange Reserves of G-15 Countries

Total reserves minus gold (billions of US$)

	1995	2000	2005	2006
Algeria	2	12	56.3	78
Argentina	14.3	25.1	27.2	30.24
Brazil	49.7	32.5	53.6	87.27
Chile	14.1	15	16.9	17.16
Egypt	16.2	13.1	20.6	26.3
India	17.9	37.9	131.9	165
Indonesia	13.7	28.5	33	43.04
Iran	na	na	na	58.46
Jamaica	0.7	1.1	2.2	2.32
Kenya	0.4	0.9	1.8	2.35
Malaysia	23.8	28.3	69.9	82.3
Mexico	16.8	35.5	74.1	85.01
Nigeria	1.4	9.9	28.3	42.97
Peru	8.2	8.4	13.6	17.04
Senegal	0.3	0.4	1.2	1.18
Sri Lanka	2.1	1	2.7	2.81
Venezuela	6.3	13	23.9	35.95
Zimbabwe	0.6	0.2	0	0.14
G-15	**188.5**	**262.8**	**557.2**	**777.54**

Source: IMF, International Finance Statistics, various reports