INNOVATIVE FINANCE FOR DEVELOPMENT SOLUTIONS

INITIATIVES OF THE WORLD BANK GROUP

THE WORLD BANK GROUP

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I. OVERVIEW

What is Innovative Finance?

Innovative Finance can mean different things to different people. At the World Bank Group, we include under this heading any financing approach that helps to:

- Generate **additional** development funds by tapping new funding sources (that is, by looking beyond conventional mechanisms such as budget outlays from established donors and bonds from traditional international financial institutions) or by engaging new partners (such as emerging donors and actors in the private sector).
- Enhance the **efficiency** of financial flows, by reducing delivery time and/or costs, especially for emergency needs and in crisis situations.
- Make financial flows more **results-oriented**, by explicitly linking funding flows to measurable performance on the ground.

Most Innovative Finance involves combining available financial instruments into a new package or using them in a new context or setting, such as a new sector, country, or region. In some cases, the driving force behind the new financial mechanism is two-fold:

to raise new resources and to make the use of those resources more effective.

Why is Innovative Finance needed in developing countries?

Low- and middle-income countries need resources for essential development needs. They need these resources in a timely and predictable manner, and they need to maximize their use of them. Yet the current global economic crisis has increased the challenges of providing timely, predictable funding.

For much of the past decade, financial conditions for development assistance were quite favorable. Interest rates and interest-rate premiums were low, and from 2003 to 2007, global credit expanded twice as fast as nominal GDP. Using a range of new financial instruments, banks were able to leverage equity capital as never before, allowing them to fund significant parts of their loan portfolios through the capital and money markets. Partly as a result, developing countries enjoyed a sustained investment boom—but that boom came to an abrupt halt in the fall of 2008.

Going forward, the challenge is to restore healthy aid levels in the uncertain environment of the continued financial crisis, while finding new modalities that can complement official sources of aid and ones that can help ensure “the biggest bang for each buck.”

How did Innovative Finance take off?

At the United Nations Millennium Summit in September of 2000, 189 nations adopted the Millennium Declaration, which set eight Millennium Development Goals to be met by 2015. These goals brought together in a single platform many of the most important commitments made separately at international conferences during the previous decade.

To help assure the achievement of the Millennium Development Goals, a variety of development partners began searching for new sources of funding—for “innovative financing” to complement traditional Official Development Assistance. Development banks began issuing new types of bonds, ones that linked resource mobilization with specific development objectives: for instance, certain debt offerings for sustainable investments were tied to climate-change goals. Sovereign and private donors championed an array of initiatives.

The World Bank’s vigorous engagement in Innovative Finance stems from 2003. The joint World Bank/IMF

Development Committee mandated the review of a number of mechanisms, including the International Finance Facility, solidarity taxes on airline tickets, voluntary contributions, debt buy-down arrangements, blending arrangements, Advance Market Commitments, commodity-linked repayments, inflation-indexed local-currency lending, and deferred repayment schemes. Many of these have been implemented in the years since.

At the same time that donors have been devising new financing mechanisms and instruments, developing countries themselves have been seeking not only increased financial flows but better, more sustainable, financial solutions—initiatives such as partnerships that mobilize private finance for the delivery of public services; risk-mitigation plans that increase incentives for private players to engage in productive sectors of low-income countries; and support for carbon-trading mechanisms.

How important is Innovative Finance in the overall development picture?

Compared to Official Development Assistance and traditional private-capital flows to developing countries, the funding from Innovative Finance instruments is as yet very small. But a huge untapped potential exists. In the United States, for example, Socially Responsible Investing (SRI)—investment decisions that take both the investor's financial needs and societal concerns into account—has already reached US$2.15 trillion in assets, or about 10 percent of the total invested capital assets. A bigger share of SRI going into developing countries, along with higher penetration rates for other innovative finance instruments in developing countries, would greatly multiply the current amounts of finance. Another example is the Solidarity Tax on Airline Tickets. Instituted by France in 2006 and adopted by 17 other countries (with 15 more in the process of joining in), it raised an estimated US$600 million up to 2008, and has the potential to generate much more as additional countries implement the tax.

When evaluating the importance of Innovative Finance, one must consider not just the amounts of investment in absolute terms but also—and more important—the leveraging effects. For example, between 2000 and 2008 the World Bank Group issued about US$7.7 billion in guarantees to support investments in financial and productive sectors of developing countries. These guarantees leveraged total investments of almost US$20 billion—a leverage ratio of roughly 2.6.

Roles of Innovative Finance Instruments: Some Key Examples