Accumulation and Mobilization of Capital for Sustainable Development – An ECA Perspective[1]

INTRODUCTION

Accumulation and mobilization of capital has been at the centre of any discussion on development economics. Adequate amount of capital, its quality and timely availability have been important determinants of development. The relevant discussion accordingly is on three central points (a) what determines generation and availability of capital for meeting development needs, (b) what determines transfer of capital to recipient, and (c) going forward, what modes of capital transfer would help achieve sustainable developmental outcomes.

In 2015, Governments from 193 countries embarked upon the ambitious 2030 Agenda for Sustainable Development, which includes a set of 17 goals and 169 targets. These Sustainable Development Goals (SDGs) serve to blend the economic, social and environmental priorities of the global economy. The achievement of these SDGs require financing of around US$ 1.6- 2.9 trillion. Actual investment required may be even higher as the green economy is at a nascent stage, and not much of statistical or even anecdotal evidence is yet available to assess the capital requirement of the transition and growth. Even if it is assumed that the initial capital investment would be of the same order, what about the capital needs for maintenance and upgrade of this new technology, which is more a function of the fixed cost incurred on equipment than the variable cost associated with operations of a conventional fossil fuel based plant. How does the world generate investible surplus of this high order?

Forms of Capital

An essential first step in this enquiry would be to define what constitutes capital. Capital, in very broad terms, includes both equity and debt Capital. Though, equity capital – common stock and retained earnings are more stable sources, debt flows have historically played an important role in financing development. Equity capital - the classical form of capital – has been accumulated, retained and invested/ deployed by society to usher in development over time, in various form as business evolved. Accumulation started with the nobility, the papacy, the agriculturists, the trading class, the artisans and craftsman, industrialist, merchants and the capitalists. The capital so invested has financed all entrepreneurial activity, including agriculture, trade and industrial development. The Great Industrial Revolution and its subsequent progenies, have been financed by accumulated capital and reinvestment of this capital. The process of development has been accelerated through accumulation of capital. Equity capital has been patient and long term and has mostly been used as “Risk Capital” in the development process. The admirable qualities of patience and risk tolerance has made it a catalyst in the development process.

Debt capital, on the other hand, does not adhere to these desirable qualities. Deployment of debt capital has always been on the basis of an assured return, over a finite period of time. Debt capital is, therefore, “Risk Intolerant”. Further, the availability and return expectations (pricing) of debt capital gets determined by the prevailing monetary and macro-economic conditions, including availability of liquidity. Easy availability of debt capital also has its disadvantages as it can lead to excess leveraging and asset price distortion, at the firm and the macro level. Despite all the associated risks, debt capital, has played a significant role in the initial development process of a capital starved economy. The

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success of debt capital has been remarkable in some economies. In some others, particularly those affected by currency depreciation, it has been less than optimal. Cross country difference in experience, has perhaps been more determined by the success of the business model of the underlying project, and the dynamism of the relative economic development process. Notwithstanding the deficiencies, debt capital will continue to retain its primacy as the principal source of capital, in the initial development process, due to sheer non availability of alternative sources. Empirically, financing for development of poor /low income countries have been supported more by the multilateral banks, development banks and ECAs, essentially by way of long term debt.

Sources of Capital – Indigenous and External

Generation of economic surplus is the primary source of capital and its accumulation, with the quantum being determined by the size and efficiency of the underlying economic order. Pace of capital accumulation has accelerated as human society has made the transition from feudalism to capitalism. Discussion and debate on the competitive efficacy of the Prussian and American way of capitalism, in economic literature, is essentially a discussion on the efficiency of the underlying economic arrangements, and its efficacy in generating economic surplus. Efficiency of utilisation can be enhanced through preferential transfer of capital among sectors. Economic surplus, if insufficient, can be supplemented by accessing foreign capital, both equity and debt.

Historically, industrial capitalism has led to faster generation and accumulation of capital than all other social production forms/ arrangements. Efficiency of a capitalist system has led to more productive use of capital and generation of higher surplus. Reinvestment of the surplus along with the associated multiplier effect has helped accelerate formation and growth of capital with all its attendant benefits. The development process of the West has been the story of growth of industrial capitalism and faster generation and reinvestment of that wealth.

In the underdeveloped countries, however, where indigenous capital/ capitalism has not taken shape, accumulation and deployment of capital has been mainly dependent on transfer of capital from external sources. The host country, depending on its ability to attract and absorb capital as also its ability to put capital into more productive and efficient use has been able to put in place a virtuous cycle of growth and capital accumulation, which has over time unleashed the indigenous sources of growth.

Transfer of Capital

Transfer of capital – both inter sectoral transfer and cross country – follows its own logic. Policy priorities and terms of trade usually would determine inter sectoral transfer (agriculture vs industry, taxation as a redistribution measure etc). Other than aid, grant, soft loan, charitable causes which would in most cases be policy driven, cross country transfer would mostly happen on the basis of commercial considerations of risk-reward ratio. Deployment of sectoral dedicated funds, viz. Green Fund, ESG Fund, Education Fund etc are also guided by commercial considerations of relative returns in consonance with the objective – though in many cases, this could be lower than the return earned in open market investment.

The risk-reward ratio of investments critically hinges on a robust domestic environment and policy framework. In order to mobilize financing, as also to facilitate its effective use according to national priorities, it is essential to have an adequate enabling environment and policy architecture that provides the necessary conditions for implementation of effective national sustainable development strategies.

Private sources

Transfer of capital, could be both from official as well as private sources and could be invested in both equity and debt capital. Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI) are two of the most common instruments of foreign capital transfers from private sources. FDIs in LDCs have mostly been in extractive industries, mines and other low skill based industries. The activities, in many such cases are directed towards the external market, through linkages which often bypass the host economy. Such activities, pursued in the aforesaid manner, have limited income enhancing/ savings impact, very low market development benefits and consequently limited impact on generation/ accumulation of indigenous capital, and the development process of the host economy. Their impact on development process and its sustainability have not been significant, though such investment has kept the activity going, and generated income for the local people. Portfolio flows through FPIs, on the other hand, have come in only when congenial institutional and market framework are developed to a reasonable extent – and not in the initial stages of development.

The depth and efficiency of the financial system influences a country's capacity to absorb capital flows, both private and official. The level of financial development also influences the extent to which a country is able to benefit from capital flows in terms of spillovers from targeted sectors to the rest of the economy, and the overall growth effects. Improvement in domestic environment potentially increases foreign investments in countries. According to World Bank's Doing Business Project, for an economy with an average distance to frontier score[2], moving 1 percentage point closer to frontier regulatory environment is associated with US$ 250-500 million of additional annual FDI inflows.

As institutional network in countries are almost non-existent at the initial stages of development and profitable opportunities to deploy capital is difficult to identify, the ability to attract and absorb private capital and portfolio flows in the initial stages of development are limited. While FDI has been a better known source of foreign capital transfer in LDCs and UDCs, private capital and its transfer have, at best, had limited impact on development in LDCs and UDCs.

Official Sources

Budgetary constraints, the cyclical but regular crisis in the financial markets, the reduced ability to tax and its avoidance, have together constrained the resources of many sovereigns. In such situations, transfer of development capital from official sources by way of grants and aid, have not been able to keep pace with the growth rates achieved earlier as well as the development needs/ aspirations of the countries.

Official data collected by the OECD Development Assistance Committee (DAC) indicates that development aid from OECD countries to poorest countries has dipped. Overall development aid by these countries reached a peak of US$ 142.6 billion in 2016, a y-o-y increase of 8.9 percent. However, bilateral aid to least-developed countries declined by 3.9 percent during the year, while aid to Africa fell by 0.5 percent.

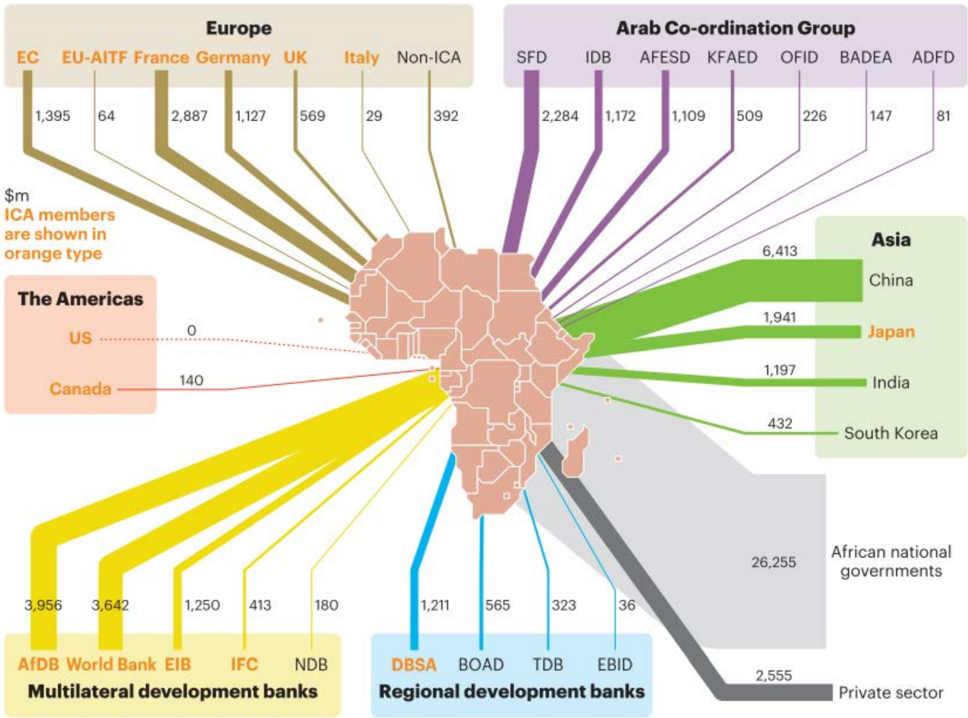
Least developed countries have depended largely on aid flows for development financing. Over the past several years, the politics of aid has been an overarching issue in the development debate. Particularly in case of Africa, since 2000, the G8 countries and OECD countries have been sceptical about the effectiveness of aid in promoting sustainable development. According to these donors, aid in these countries are not conforming to the conditionality of good governance and democratic

[2] Distance to frontier score assesses the absolute level of regulatory performance of countries over time. It measures the distance of each economy to the "frontier", which represents the best performance observed on each of the indicators in the Doing Business project.

reform. This has severe implications for the least developed countries, as ODA makes up for more than two thirds of external finance in these countries.

While the traditional donor countries are stumbling to find practical ways to ensure that aid is being effectively used to promote sustainable development, and reducing their efforts in the least developing countries, countries such as China and India are increasing their presence in the global developmental landscape. In fact, these two countries are now among the major financiers of infrastructure development in the African continent (Figure 1). Export credit through financial institutions is one of the chief tool for financing development which is being used by China and India.

Figure 1: Sources of Finance for Africa's Infrastructure (2016)



Source: ICA

Institutional Sources

Transfer of development capital on the other hand, has been mostly by way of long term, concessional/ soft loan from Multilateral Development Banks (MDBs), Domestic Financial Institutions (DFIs) and Export Credit Agencies (ECAs). These institutions were all set up to channelize resources, both from domestic and foreign sources, into development spending.

Multilateral Development Banks

MDBs present another major source of development financing, with several of them now placing sustainability at the core of their financing objectives. MDB financing presented a palette of possibilities for developing countries in the past, but financing from these entities are increasingly being restricted to the green and clean areas. There is no debate on the need for green and sustainable financing, however, intermittent, unreliable and expensive renewables like wind may not be the best option for all developing countries, and these need to be adequately balanced with power generation through fossil fuels. According to the UN, the cost of universal energy access is just US$ 50 billion a year, but that is only if it comes from fossil fuel. Meeting the energy requirement through renewables may significantly increase the financing requirement. Coal-fired power stations can help bridge developmental challenges in a country like Nigeria which has substantial reserves of coal, but financing for such power projects from multilateral sources is decreasing rapidly in the wake of increasing focus on cleaner and greener projects.

Most of the MDBs today are resource constrained, and consequently in a process of role transition. The ability of the traditional MDBs, in development funding, appear to be on the wane. New MDBs such as the Asian Infrastructure Investment Bank and New Development Bank are being conceived, though one is yet to be sure of their impact.

Development Financial Institutions (DFIs)

DFIs have historically played a crucial and significant role in the initial development process in many such countries, by channelizing domestic and foreign savings towards productive sectors. Success of such banks have been observed mostly at a stage when the host country has already embarked on preliminary development process/ activity, has some indigenous savings and wealth generated, put in place a taxation system, created a congenial institutional mechanism and has the ability to absorb capital, transferred from external sources.

In case of poor countries, as also countries at the lower end of the development scale, such favourable macro parameters are usually absent. Income and savings are low, concentrated and not well distributed, system of taxation is underdeveloped and suffer from leaks, and the institutional mechanism is not developed. Sources of capital, in such countries, are mainly external, viz. from multilateral banks, Export Credit Agencies, private capital through direct investment, and also portfolio flows. However, lack of institutional set up and market depth, slow pace of development, lack of identified opportunities, perceived lack of governance and lack of general confidence has impeded flow of private capital to supplement resources available with the DFIs in the poor and LDCs/ UDCs. In view of this, birth of major DFIs, as had happened early in the development process of China and India, seems unlikely in the poor countries and LDCs/ UDCs.

Export Credit Agencies

In recent years, the Export Credit Agencies (ECAs) have been increasingly taking a more active role and have been able to transfer resources of a high order to underdeveloped countries. The role of export lending institutions such as EXIM Bank of India, Export-Import Bank of China, Export-Import Bank of Korea, Japan Bank for International Cooperation, and export credit guarantee institutions such as ECGC Ltd., China Export and Credit Insurance Corporation, Korea Trade Insurance Corporation, and Nippon Export and Investment Insurance have been significant. The ECAs have mostly extended assistance for infrastructure and other development projects. Roadways, power transmission facilities, ports, railways etc., which are growth enhancing have been supported by ECAs through their lending and guarantee/ insurance products. Direct lending by ECAs can meet the financing requirements of infrastructure projects. ECA support through guarantee/ insurance products can act as a lever to facilitate additional commercial financing of projects. Both financing and insurance/ guarantee products lead to increase in the quantum of finance available for development projects, and also ensures cheaper project costs for importers.

Assistance by the ECAs are long term and concessional, and is usually denominated in hard currency, usually USD. The capital transfers by these ECAs are usually programme specific, and could have a large multiplier effect, if properly designed, suitably adopted and delivered.

Programme-Specific Nature

ECA assistance, in a short span of time, has been able to promote large scale infrastructure facilities. Though in most cases, the facilities and design of such projects finalised and awarded by the host country, have been beneficial, there could be a tendency to overbuild and overdesign in some cases, due to easy availability of concessional financing. The facilities in such cases might remain unutilised or sub-optimally utilised. There could be situations wherein downstream and/ or supporting infrastructure are not being built in sync with the principal project, which can lead to less than anticipated benefits from the project. There have also been cases where spare parts/ machine parts and other maintenance and essential facilities are absent, and/ or training of staff have not been imparted by the host country. In some cases, capital goods import are also not adequately designed, and the imported capital good outlives its utility, while the loan still continues. These could be considered as defect in designing the project / assistance.

Tied Assistance

In spite of all the beneficial impact of the ECA programme, the assistance usually requires a minimum percentage of the assistance to be utilised for financing imports from the ECA home country. This conditionality has a possibility of impeding the growth of capabilities of the host country, with all its attendant multiplier benefit, so essential in the entire development process. In the interest of development of LDCs/ UDCs, it may be desirable to explore the prospects of imparting an increasing part of the development assistance programme, on a graded basis, to the host country. While, third country imports could be strictly restricted, creation and utilisation of facilities of poor LDC/ UDC host country are congenial and beneficial to the development process.

Currency Mismatch

As the currency of most of the beneficiary LDCs/ UDCs are weak vis-à-vis their borrowing in hard currency, there is a potential problem of inability to pay which may result into a debt default under the programme. This aspect is of central importance, and has been particularly underscored during the recent financial crisis, and its negative impact on primary commodity prices which are often the main exports of these countries. There is an urgent need to explore remedies for such issues. A plausible solution could be setting up a deep Exchange Risk Administration Fund by the ECAs and multilaterals, which could have suitable economic dynamism and enablers to set up Currency Swap facilities among such nations, or provide Credit Insurance Cover against the adversaries of Exchange fluctuation. Though attempts in this direction have till now not been successful, improved focus is required in this direction. As assistance from ECAs is increasingly becoming an important source for development transfers/ financing, it is necessary to have a concentrated focus on this. There is a need to explore the possibility of supporting cross country capital accumulation through currency swap mechanisms among emerging markets, to avoid currency risk and also to reduce the cost of using the intermediate currency. The Currency Exchange Fund (TCX) founded by a group of DFIs has been a step in this direction, offering financial instruments that enable investors to provide their borrowers with financing in their own currency, while shifting the currency risk to TCX. Such initiatives need to be intensified so that local currency financing can be expanded and borrowers are protected from currency volatility.

Conclusion

Accumulation and mobilization of capital has been one of the critical tools for development of economies. The earlier phase of development was catalysed through a mix of capital sourced from sovereigns, institutions including MDBs, DFIs and ECAs and the private sector. The necessary condition for such sources of capital to result in sustainable development, inter alia, included the ability of the economies to constructively absorb such capital and simultaneously utilise it for spawning domestic ancillary industries. In the current scenario, capital is increasingly becoming scarce, reflected in the declining trend in ODA, moderation in flows from MDBs, as also in the stressed finances of the sovereigns of underdeveloped countries seeking foreign capital. Such countries, for various reasons, are not perceived as attractive destinations for foreign private capital. In such a situation, these countries are increasingly looking at ECA support, which is perhaps relatively easier to get, especially from the emerging market ECAs, which view underdeveloped countries from an entirely different perspective. In order for this type of ECA support to have a lasting impact, it is important that projects are designed and developed in a coordinated manner with strong involvement of the host country. This involvement should accord high priority to the key elements of local development including participation from host country enterprises in setting up the project initially and then subsequently in its operation and maintenance. Thus, traditional ECA support needs some modifications and reinvention to ensure that their support creates a sustainable impact. Exim Bank of India, as a responsible ECA, has been continuously evolving and redefining its support to partner countries and help them in catalysing local economic development. With availability of complementing ecosystem including one that encourages local currency financing that could eliminate exchange rate volatility and foster a significant improvement in debt sustainability, coupled with a phased approach of mandating a floor for local content requirement could substantially drive ECA support as the major tool for ushering in sustainable development.

P.S.: The views presented in the article are personal and do not necessarily represent that of the Export-Import Bank of India