

Review of the Monterrey Consensus on Financing for Development February 15, 2008 Review Session on Mobilizing International Resources for Development: Foreign Direct Investment and Other Private Flows

U.S. Government Submission

The 2002 Monterrey Consensus identifies mobilizing international resources for development, including foreign direct investment (FDI) and other private flows, as one of six “leading actions” or pillars in support of financing for development (FfD). The Consensus sets out a number of commitments by both developing and developed countries that together acknowledge the important contribution of FDI toward financing sustained economic growth (see box).

Monterrey Consensus: Mobilizing international resources for development (*key commitments*)

- Transparent, stable, and predictable investment climate
- Promoting and protecting investment through economic policy and regulatory frameworks
- Increase support for private foreign investment in infrastructure and other priority areas
- Support for new public/private financing mechanisms
- Improve transparency of financial flows
- Debt management, strengthening prudential regulations, orderly capital flow liberalization

Both domestic and international conditions are necessary to facilitate direct investment flows to least developed countries (LDCs). Each country is primarily responsible for introducing and maintaining a transparent, stable and predictable investment climate. Supporting crucial domestic reform efforts is the complementary role of international and source-country institutions in promoting FDI. Similarly, the Consensus encourages businesses to consider creative partnerships with government and invites banks and other financial institutions to foster innovative developmental finance approaches. Such public-private efforts can also help the development of small and medium-sized enterprises (SMEs). Finally, the Consensus

recognizes that sound monetary and fiscal policy and prudential supervision of financial institutions complement transparent, stable, and predictable conditions for investment and help ensure that any volatility of short-term capital flows is transitory.

U.S. companies are the leading source of FDI in developing countries worldwide and invested more than \$104 billion in developing countries from 2002-2006. Given the usefulness of FDI in raising growth rates and facilitating mutually advantageous technology transfer and international linkages, the U.S. Government has implemented a number of initiatives to help developing countries attract more and higher quality FDI. These initiatives are described in the attached fact sheet.

Progress Since 2002

The substantial, broad-based increase in FDI flows to developing countries since 2002 has been an important contribution to financing for development. FDI flows to the developing world increased by 92% between 2002 and 2006, rising to a record of \$325

billion. Representing roughly one-half of net resource flows, FDI is the single largest external source of resource flows to developing economies, including other private sources, such as portfolio equity and debt, and official sources, such as loans and grants. FDI's full value, however, lies in its ability to stimulate competition, spur innovation, introduce new technologies and processes, and elevate the skills of workers and managers in developing countries. FDI makes it possible to raise rates of capital accumulation in both physical and human resources. FDI projects also create new production capacity and jobs, often at higher wages.

Over 40% of the FDI associated with these gains is seeking efficiencies through participation in cost-effective global networks. This trend is evident through the economies of scale captured by global banking, insurance and transportation investors, and regional telecommunications networks. Most of the remaining FDI is associated with positive trends in human capital formation and technology transfer when foreign affiliates of major wholesalers or retailers enter developing country markets and introduce new information management processes or marketing techniques, yielding improved productivity in the local market. These increased efficiencies are especially evident in the services sector, now accounting for over half of the FDI stock in developing countries. Manufacturing, which employs lower skilled labor and enables export-led growth, has also been important, accounting for 29% of greenfield projects in LDCs during 2002-2004. Between 1990 and 2004, developing countries experienced growth in the value of their FDI stock in all major manufacturing industries, although shares are changing as the sector becomes driven more by technology than labor costs.

In recent years, many developing countries have enhanced their attractiveness as investment destinations by providing macroeconomic stability and implementing reforms aimed at fiscal discipline, debt management, privatization, protection of property rights, transparency and the reduction of distortions from administrative barriers. According to World Bank's Doing Business survey, many large emerging economies (e.g., China, Egypt, India, Indonesia, Turkey and Vietnam) have reformed their business climates substantially. Africa is reforming, but it lags behind other regions in the pace of reform, which is also not uniform across the continent. The World Bank has cited some sub-Saharan African countries, including Ghana and Tanzania, as top reformers in their Doing Business indicators.

Building on accelerating reforms and a favorable world economic environment, African economies have experienced their strongest real GDP growth (approximately 5% from 2004 to 2006) and lowest inflation in nearly three decades. However, sustaining and improving this performance requires further reforms to the business climate and financial sector in many countries, and should be a priority for action.

Consistent with the Monterrey Consensus, private participation in key sectors is fundamental to economic growth, new employment, and higher wages. For example, *FDI support for infrastructure projects in the developing world has rebounded rapidly from earlier regional financial crises to reach a total of \$96 billion in 2005, an increase of over 80% from 2003.*

Recognizing the role FDI source countries play in encouraging business climate reform, the United States negotiated a bilateral investment treaty (BIT) based on a high standard model, or similar provisions through Free Trade Agreements, with 17 countries since 2002. While the precise relationship between levels of FDI and the presence of a BIT is difficult to demonstrate, investors indicate that they place high value on high quality investment treaties.

After FDI, remittances remain the largest source of external financing flowing to developing countries. According to the World Bank, recorded remittances sent home through formal channels by migrants from developing countries reached \$240 billion in 2007, up from \$221 billion in 2006 and more than double the level in 2002. However, the actual amount of remittances, including unrecorded flows through informal channels, is thought to be considerably larger.

The private sector is also responsible for deepening capital markets in much of the developing world, thereby improving the availability and lowering the cost of credit. Equity continues to account for the bulk of capital inflows to developing countries, as equity prices in emerging markets continue to outperform those in mature markets despite transitory episodes of volatility. *Portfolio equity flows to developing countries have continued their surge, reaching a record \$94 billion in 2006, up from less than \$6 billion in 2002.* Further, *the private sector has emerged as the major source of developing countries' external borrowing* over the past few years. In 2005–06 corporate bond issues (including corporate bonds guaranteed by the public sector) accounted for over half of the value of all developing country external issues, up from less than 25 percent in 2000.

New Challenges and Emerging Issues

Debt-relief initiatives (HIPC and MDRI) are significantly reducing the debt burdens of many of the heavily indebted low-income countries. These initiatives have reduced the debt stocks of the 23 countries that have completed the process by almost 90% and reduced debt service by about 2% of GDP between 1999 and 2006. This substantial debt relief, coupled with improved performance on economic reforms, has permitted some HIPC or MDRI countries to borrow limited amounts on nonconcessional terms and to begin to access capital markets. A challenge to this positive development is the risk of governments and state-owned entities borrowing excessively from commercial and other sources on nonconcessional terms, compromising hard-won gains in sovereign debt sustainability.

The World Bank estimates that small and medium enterprises (SMEs) account for over half of GDP in high-income countries, but only 15.6 % of GDP in developing countries. SMEs in developing country markets have the capacity to capture innovations embedded in the human and technological transfers that accompany FDI. The U.S. Government has a number of programs to strengthen the “missing middle” (see attached fact sheet).

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Fact Sheet on U.S. Government Assistance Programs

FDI and other private flows are key ingredients to private sector led growth in developing countries. The United States has launched a number of innovative programs to facilitate FDI when the private sector is unlikely to enter into a developing country without assistance, for example, for reasons of political risk. The U.S. has also provided extensive technical assistance to many developing countries aimed at helping them develop a welcoming enabling environment for FDI that will translate into higher levels of economic growth and development.

Focus on Africa

In 2002, President Bush announced the creation of a new **Millennium Challenge Account** devoted to providing assistance to projects in nations that govern justly, invest in their people, and encourage economic freedom. The Millennium Challenge Corporation (MCC) attention to policy reform associated with improved business climates is a criterion for participation in grant programs, for which almost \$6 billion has been committed globally, over half of that amount to Africa. MCC compacts with developing countries are designed to address systemic and structural barriers that prevent growth and impede business and MCC is working closely with the private sector to encourage sustainable private sector investment.

The United States has partnered with Africa to improve the regulatory environment and encourage investment. In May 2007, President Bush launched the **Africa Financial Sector Initiative (AFSI)** to provide technical assistance and mobilize capital to help African nations strengthen their financial markets and mobilize capital for African entrepreneurs.

As one element of the initiative, the **Overseas Private Investment Corporation (OPIC)** is creating private equity funds to mobilize up to \$2 billion in investment in Africa in sectors that support capital market development and spur innovation, including telecommunications and healthcare.

The **U.S. Department of the Treasury** will continue its work to strengthen country and regional debt markets by providing up to 10 expert advisors to African governments. The Treasury Department assisted the Government of Uganda in the design and sale of its first two-year bond, which was followed quickly by three, five, and ten year maturity issues, thereby significantly extending the yield curve for the country's debt. Technical assistance from the Department of the Treasury also played a crucial role in Ghana's debut \$750 million Eurobond issuance in September 2007. This was the first external

bond issuance by a post-HIPC country and the first by a sub-Saharan African country (outside of South Africa) in decades.

Microfinance and Financial Inclusion

The **U.S. Agency for International Development (USAID)** has joined with private sector institutions to create the **Global Commercial Microfinance Consortium** to provide local currency financing to microfinance institutions. The U.S. microfinance program reaches over 5 million clients worldwide with total combined loans of more than \$2.5 billion. Forty percent of borrowers are women.

Recognizing the enormous potential represented in using remittances as proof of income to support a mortgage, micro- or SME loan, OPIC has recently started working with the Microfinance International Corporation to broker transitional loans to remittance senders and recipients. Likewise, USAID is working to reduce high transaction costs associated with remittances by offering low-cost money transfers between credit unions in the United States and Latin America. USAID is also collaborating with the Pan-American Development Foundation to pilot collective remittance programs through migrant or “hometown” associations in El Salvador, Haiti, and Mexico.

The Treasury Department began its remittance work in 2001 with the Partnership for Prosperity Remittance Initiative with Mexico. Since then, the Treasury Department has launched a series of complementary multilateral and bilateral initiatives, including the G7 Sea Island Global Remittance Initiative, the APEC Remittance Systems Initiative, and the US-Guatemala Bilateral Remittances Pilot. Treasury’s work is guided by a global remittance strategy that focuses on five key shortcomings: financial infrastructure inadequacies, weak financial literacy, limited access to financial services, constraints on competition, and unnecessary regulatory barriers to entry. Treasury’s work is increasingly focused on financial inclusion, as it is among the most critical factors in deepening the development impact of remittance flows.

Improving Governance

MCC has pledged more than \$82 million in multi-year funding for anti-corruption activities through its Threshold Country programs in six African countries: Kenya, Malawi, Niger, Tanzania, Uganda, and Zambia. Additionally, in 2006, U.S. anti-corruption assistance included almost \$8 million in bilateral and regional programs managed by USAID and **the State Department**, including USAID's regional **Anti-Corruption Initiative (ACI)** that provided funding to nine African countries: Benin, Nigeria, Rwanda, Kenya, Tanzania, Mozambique, Madagascar, and South Africa. Programs seek to build capacity of a range of government and civil society organizations to encourage greater government accountability through audit institutions, parliamentary oversight committees, independent anti-corruption bureaus, district reporting centers, commercial crime courts and internet programs publishing government budget data to increase transparency.

Supporting Infrastructure Investment

The United States has built a network of business alliances with an emphasis on innovation in infrastructure. Since 2002, USAID has forged 600 alliances in various infrastructure sectors with over 1,700 private sector partners, leveraging \$5.8 billion of private contributions with a public sector commitment of \$2.1 billion. Areas of priority include energy, information and communication technology, water, agriculture, and financial services.

MCC encourages partner countries, as they develop their MCC programs, to engage in early dialogue with the domestic and international private sector, to identify constraints to investment, to explore how they might leverage MCC resources with private sector investment, and to identify potential private investment opportunities resulting from the MCC program.

Development Partnerships with the Private Sector

Over the period 2002-2006, OPIC efforts have channeled almost \$21 billion in US foreign direct investment, over \$5 billion in domestic investment, which supported over 125,000 jobs in emerging markets.

The U.S. Trade and Development Agency (USTDA) provides project preparation assistance to define the technical, legal, financial and other requirements of infrastructure and related development activities in developing and middle-income countries. USTDA provides access to U.S. private sector expertise to perform assistance activities including investment analysis, project definition, sector development, and trade capacity building.

Demonstrating the growing cooperation between the U.S. and Chinese energy sector interests targeted under the Asia Pacific Partnership on Clean Development and Climate (APP), a \$500,000 USTDA grant to a Chinese coal mining group leveraged \$120 million of investment to build the largest coal mine methane-powered facility in the world. This facility will eliminate the equivalent of one million cars' annual emissions, and use state-of-the art equipment from APP participant Caterpillar.

In April 2007, USTDA launched the U.S-India Aviation Cooperation Program (ACP), a public-private partnership between USTDA, the U.S. Federal Aviation Administration, and U.S. aviation companies. The ACP will identify and support India's civil aviation sector modernization priorities and serve as a mechanism for Indian and U.S. civil aviation representatives to highlight areas for bilateral technical cooperation.

Construction is underway on the \$174 million San Bartolomé Silver Mine Project in Bolivia following USTDA cost sharing of an investment analysis with its private sector partner, Coeur d'Alene Mine Corporation of Idaho. It is expected that the mine, which will support up to 850 direct and indirect jobs, will have a broad developmental impact in terms of road construction and the use of advanced technologies to protect the environment and clean-up past contaminants. Coeur d'Alene has also established a

development fund that will invest in economic and social projects, such as the expansion of the tourism sector and the development of a local silversmith artisan industry.

A USTDA technical assistance grant to the State Oil Fund of Azerbaijan (SOFAZ) led to the establishment of an asset and risk management system for the country's oil-related revenue. SOFAZ selected the Bank of New York as the global custodian for its assets (now over \$2 billion) and Thomson Financial for its management systems. As a byproduct of this assistance, SOFAZ received the 2007 United Nations Public Service Award for Improving Transparency, Accountability and Responsiveness in the Public Service.

