

Ten Myths of the International Finance Facility
By Todd Moss**Abstract**

The British proposal to create an International Finance Facility in order to ‘frontload’ \$50 billion in aid per year until 2015 has generated a lot of attention and will likely be a major topic at the G8 meeting this July. But the IFF has also been shrouded in confusion and misconceptions. This paper explains the IFF proposal and highlights some of the common misunderstandings surrounding it, including the mechanics of the scheme itself, the potential for a U.S. role, and the expectations of aid which underlie the IFF’s premise. The UK deserves plaudits for elevating global poverty on the international agenda and for seeking ways to better harness the power of private capital markets for development. But the IFF, as currently conceived, is an idea that merits more scrutiny and a healthy dose of skepticism.

Ten Myths of the International Finance Facility

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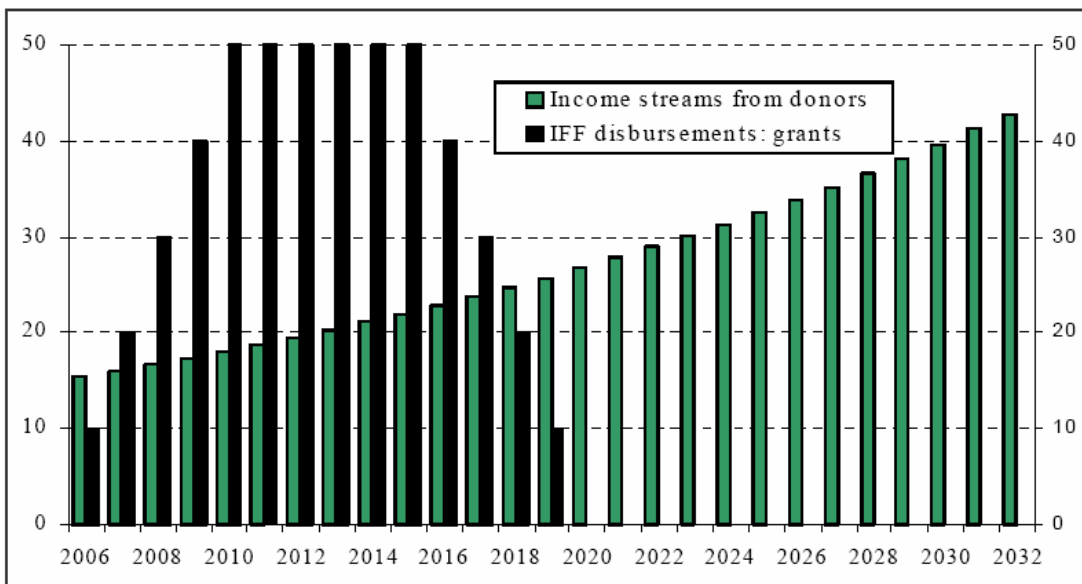
¹ Comments welcome on tmoss@cgdev.org. The contents and opinions expressed in this note are strictly those of the author and do not necessarily represent the views of CGD, its staff, or its board of directors. I thank my CGD colleagues, especially Owen Barder, Michael Clemens, and John Hicklin, for their helpful comments.

Introduction

This year promises to be a big one for the United Kingdom and its hopes to elevate efforts to fight global poverty. In 2005 the British are chairing the G8, holding the presidency of the European Union, and have already released a major report from the Commission for Africa chaired by Prime Minister Tony Blair. All of this will help set the stage for a United Nations summit in September to review progress toward the Millennium Development Goals (MDGs). The UK is using its high-profile and the confluence of events to make a series of proposals on aid, trade, and debt relief for low-income countries—and none is bigger or more prominent than their plans to create an International Finance Facility (IFF).

The IFF, first proposed by Chancellor of the Exchequer Gordon Brown in 2003, is a scheme to ‘frontload’ aid disbursements by borrowing from private capital markets.² The premise is that an immediate additional \$50 billion in aid is needed each year to fill the ‘financing gap’ if the world is to reach the MDGs by 2015. Since donor governments have only promised a portion of these resources, the IFF wants to lock-in future pledges and bring them forward by borrowing against those promises. The plan is that donors will make 15-year aid commitments and the IFF will issue bonds against those commitments allowing access to the money today (see Figure 1).

Figure 1: IFF disbursements and income



Source: HMT

The British claim that the IFF will enhance both the quantity and the quality of aid. One of the major purported benefits—and indeed the underlying rationale for the scheme in the first place—is that the IFF enables aid budgets to be ramped up immediately by avoiding the short-term

² www.hm-treasury.gov.uk. The latest available version of the IFF proposal is dated Sept 2004.

political pressures that may be preventing larger aid allocations. (Less diplomatically put, the IFF will use allow the circumvention of parliament and the usual national budget processes in order to increase aid flows.) The British also anticipate that the IFF will also allow better quality aid, especially stable and predictable flows that are targeted for poverty reduction.

The British are making a big push on the IFF in 2005, which they hope to launch next year. The Commission for Africa formally endorsed it³ and the UK has been aggressively lobbying for support from the major donors, aiming for official adoption at the G8 Summit at Gleneagles in July. So far, France and Italy have publicly agreed to participate, while Germany and some of the smaller northern European donors have indicated nonspecific support. The IMF and World Bank have each been generally supportive in public and have agreed that the IFF may be ‘technically feasible,’ but they have raised questions about governance, fiscal transparency, and the mechanics. Top officials at the Bank and Fund have agreed that the IFF was worth further consideration.⁴ The U.S. and Japan have been quietly skeptical.

The British government and especially the Chancellor deserve plaudits for taking the problem of global poverty seriously and for seeking ways to better harness the power of private capital markets. However, the IFF and the way it is being sold are rife with misconceptions and based on some dubious assumptions. I highlight here some of the common misunderstandings surrounding the IFF, including the mechanics of the scheme itself, the potential for a U.S. role, and the expectations of aid which underlie the IFF’s premise. These questions are raised in the hope of adding to the public discussion and evaluation of the IFF relative to other policy options for enhancing aid and promoting global development.

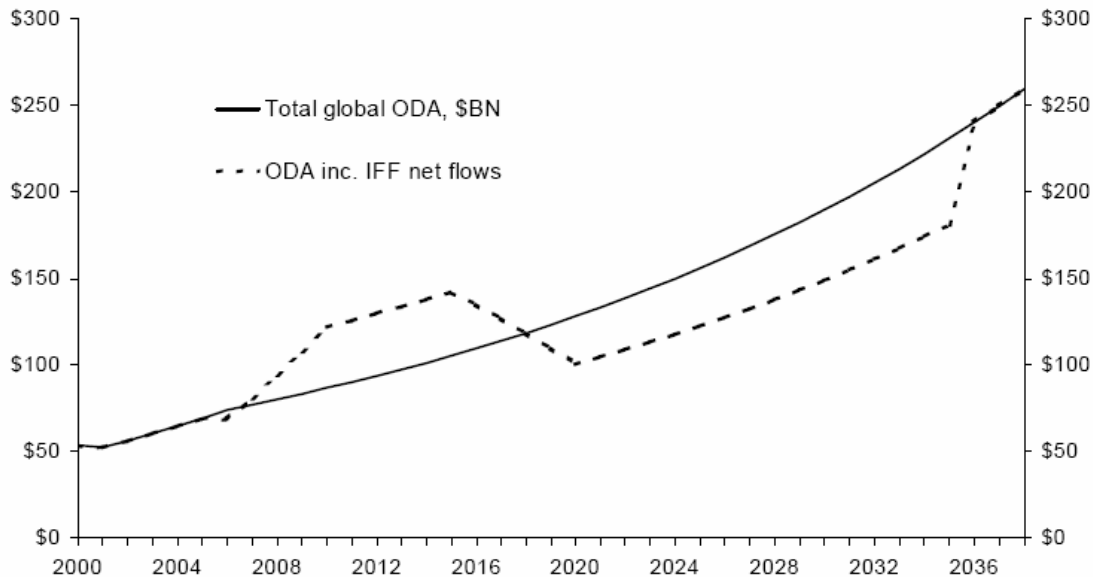
Myth #1: The IFF creates additional resources for development. Simply false. Despite the frequent use of ‘additional’ in the IFF description and in the media, the IFF by itself simply does not create any new resources.⁵ In fact, given that interest needs to be paid (and at a premium; see Myth #2), the net effect on aid flows is actually negative. The IFF merely brings forward future aid promises, thereby locking donors into their pledges (see Figure 2). This may in practice lead to a net gain since donors have historically tended not to fulfill all their aid pledges. But the extra costs only seem worthwhile if donor governments choose to pay the premium in order to tie their own hands. Instead, it is not hard to imagine how the IFF could instead erode future aid, more than undercutting any upfront ‘additionality.’ The proposal claims that it will not affect future aid because governments have already indicated they will increase long-term aid budgets. But this is a doubtful assumption, especially with a likely cycle of fiscal belt-tightening on the horizon and the very real prospect of a political backlash against aid (see Myth #9).

³ Commission for Africa (2005), *Our Common Interest*, 2005, see p. 333-335.

⁴ IMF & World Bank, *Financing* (2004), “Modalities toward the Millennium Development Goals, Progress Note,” April 12, 2004. See also “Aid Effectiveness and Financing Modalities,” September 28 and September 2004 statements by James Wolfensohn and Rodrigo de Rato.

⁵ Another recent example is the 2005 *African Economic Outlook* from the OECD and the African Development Bank, which claims that the IFF could provide “substantial additional funds for [reaching] the MDGs in time” (p. 23).

Figure 2: Frontloading aid under the IFF



Source: HMT Note: Assumes underlying 4% growth in ODA.

Myth #2: The extra financing costs of the IFF are justified. Probably not. The proposal makes the claim that borrowing through the IFF makes sense because the rates of return from ‘investments in poverty reduction’ are greater than the cost of borrowing. This may or may not be the case,⁶ but such reasoning only rationalizes *any* borrowing for development. To justify the IFF specifically, the case needs to be made that the benefits of the scheme are so great that the *additional costs of the IFF* are worthwhile. Otherwise, it makes more sense to borrow through normal channels with lower interest rates and lower transactions costs, such as regular fiscal operations or through the World Bank.

These additional costs of the IFF are not negligible. The interest rate demanded by bondholders of IFF debt will ultimately depend on the structure and the participants (both yet to be determined). Given that the UK and France are both AAA rated, there is a high likelihood that IFF debt will earn a similar credit rating. (Italy was downgraded to AA- in July 2004, so their inclusion may be a double-edged sword.) In any case, IFF debt, because it is off-budget, will certainly require *some premium* over regular treasury-issued debt. After all, bondholders will need an incentive to buy IFF debt over treasury paper. Goldman Sachs (which, of course, has an interest in underestimating the costs since it hopes to be hired to handle the deal) has indicated that 50-60 basis points is likely to be the premium range. This may sound small at first. However, the IFF plans to raise \$500 billion over 15 years, with a 30-year repayment schedule.⁷ Using the proposal’s baseline of a 5% interest rate, this implies about \$220 billion in total

⁶ Even if it is true, it is not infinitely so. Instead, there are steep diminishing returns to additional aid; See Myth #8.

⁷ There seems to be some confusion on the proposed repayment schedule. IFF documents and analyses frequently claim that payments will begin after 2015 suggesting a long grace period for IFF debt, but the figures (including Figure 1) appear to show that debt servicing will begin immediately.

interest charges over the life of the facility. But assuming the low-end 50 basis point premium, this suggests that donors will pay *at least \$24 billion in extra interest costs, over and above the regular interest charges.*⁸ Proponents of the IFF, therefore, must justify not only the ordinary interest payments, but also these additional costs from borrowing through the IFF instead of through normal treasury operations or existing MDB facilities. This seems especially necessary given that nearly all of the major donors are already running fiscal deficits—in effect already borrowing to finance their aid budgets.

Myth #3: American participation is essential. Not at all. The British have been aggressively lobbying for the U.S. to join despite all signals that there is little interest in the Bush administration. In the words of one colorful official, "We said no at dinner, we said no on the car ride home, we said no on the front porch, and he still said come to bed."⁹ The U.S. is the largest single donor and sole global superpower, so the British would obviously like American participation. This would help with the burden-sharing for financing future IFF debt and is likely to encourage even more donor governments to enroll. Since the U.S. is last among the OECD in its aid as a ratio of GNI at 0.15%, the British also think this could help the U.S. catch up more quickly. But in practice there is no reason the IFF cannot go ahead with only a small coalition of willing Europeans.

Myth #4: The U.S. could participate in the IFF if it wanted. Not really. The basis for the IFF is that governments, which are believed unable to get parliamentary approval to ramp up aid budgets because of short-term fiscal constraints, can use the IFF to assume new debt which is technically off the national accounts. This is only possible because of an accounting trick: an EU accounting rule does not count debt that is issued by a supranational facility as long as no single nation holds the majority. Thus, the British need at least three participants for the IFF to keep each country's obligation below 50%. For EU members this may be an attractive option for getting around Maastricht budget limits. But the U.S., Japan, and Canada are not part of the EU, and any debt issued through the IFF would have to be accounted for, as per any other kind of debt. The practical effect for the U.S. would thus be simply to pay higher interest rates on that debt (i.e., the difference between IFF debt and regular U.S. Treasury bills, which is likely to exceed 100 basis points). This not only makes no fiscal sense, but could certainly incite an uproar—and backlash against aid—in Congress.

Myth #5: Aid today is better than aid tomorrow. Not necessarily. Certainly there are some kinds of aid where up-front spending could be cost effective, such as investing in immunization and other preventive health care. But if we consider the financing needs for large scale infrastructure and social service provision (two sectors likely to absorb any new aid disbursements), they both have very long-term financing requirements if any gains are to be sustainable. Anyone who has driven on African roads knows that building them is the easy part;

⁸ This does not even include another additional cost of the IFF: the fee paid to the investment bankers. Even if a substantial discount is negotiated, these costs are likely to run into hundreds of millions of dollars and must still be considered.

⁹ Quoted in Sebastian Mallaby, "Say Yes To Europe," *Washington Post*, February 21, 2005.

it is the maintenance that is trickier. Building hospitals and schools is also relatively simple; it is stocking and staffing them that prove the real challenge. This suggests that long-term recurrent expenditure issues may be just as important—or more so—than short-term capital investment. We can see this in the examples of countries which successfully used aid to grow out of poverty. Botswana and South Korea received aid, not in a huge wave, but rather in steady moderate amounts over decades. This suggests that long-term sustained flows of assistance may be preferable to a ‘big push’ or the frequent calls for a ‘Marshall Plan for Africa.’

Myth #6: Spending an extra \$50 billion per year is feasible. This is doubtful. The architects of the IFF rightly point out that poverty is still a scourge that affects two billion people and that six million children die before their fifth birthday. But great need does not mean that great amounts of new money can be spent effectively in a short-time period. There are multiple constraints on a recipient country’s ability to quickly absorb funds and spend them wisely. Proponents of big aid increases correctly argue that many of these problems, such as volatility or project proliferation, are on the donor side and can be resolved through mechanisms like the IFF or donor pooling. But many of the constraints are on the recipient side too, and these are homegrown and not amenable to quick-fixes. Poor budgetary management, a weak skills base, and inadequate infrastructure are inherently long-term issues that will take many years to improve. The IFF and similar plans for rapid scaling up are simply too dismissive of these real limitations and overly optimistic about the time required to overcome them.

Massively increasing aid could be arguably achieved if distribution was less of a concern. But the intention of the IFF is to finance poverty reduction activities especially in the poorest countries. It does appear that some low-income countries with good policies and reasonably strong institutions are better able to utilize and absorb large amounts of aid. But many of these countries—the donor favorites such as Uganda or Mozambique for instance—already receive relatively large flows of aid. Indeed, nearly two dozen African countries receive aid worth more than half of total public expenditure. Although some countries could clearly use extra resources, the scope for across-the-board doubling or tripling of aid flows does not seem practicable. The countries that could absorb the most aid are China and India, large fast-growing economies which currently receive very little aid (0.13% and 0.36% of GDP, respectively). Ironically, neither really wants much more.

Myth #7: The IFF is a major step forward in aid quality. Yes, but many of the bigger quality gains are probably going to be discarded. As currently proposed, the major qualitative benefits of the IFF are (a) disbursement in grant form (b) untying aid from goods or services from any particular donor and (c) increasing predictability through multi-year programs. Each of these is a good idea. Grants should help to avoid future debt problems. So-called ‘tied aid’ inflates costs and creates inefficiencies. Predictability will help recipients integrate aid into their budgets. But all of these issues are already being dealt with outside of the IFF. Most bilateral aid is already in grants and the World Bank’s grant window was expanded in IDA-14 to include almost all low-income countries. The UK and many others have already untied aid, leaving only about one-fifth of all bilateral aid still tied. The principal gain from the IFF would thus be improved stability of flows through multi-year programs since bilateral aid is notoriously

volatile. Nevertheless, the World Bank already makes three-year commitments and there is nothing preventing bilaterals from making similar commitments on their own.

Yet these are far from the worst problems affecting aid and many of the real potential quality enhancements are being passed over. As a result, instead of radically remaking the international aid system, the IFF could wind up merely reinforcing some of the reasons aid works so poorly. Unfortunately, the IFF does little to attack the most obvious problems with the current aid system: fragmentation, political interference, and a weak link to outcomes. Clear and transparent allocation criteria would be a major leap forward in improving selectivity and avoiding waste and duplication. The IFF merely proposes that countries with prolonged arrears to the IMF be barred, which excludes only five countries (Iraq, Liberia, Somalia, Sudan, and Zimbabwe).¹⁰ Perhaps most importantly, the IFF could be a vehicle for distributing funds in a way that encourages competition among the multiple donor agencies. This would not only be more efficient, but would force the aid agencies to improve operations and measure their own effectiveness.

These potential benefits could end up far outweighing more money—and, in fact, might even help to justify higher flows by encouraging aid that actually works. Instead, the latest plan is that cash raised through the IFF will simply go back to the national aid agencies in the same proportion to which their respective governments promise to back IFF debt. In other words, the UK's Department for International Development and its French and other counterparts will use the IFF to gain extra budget, but otherwise it's business as usual. Merely shoveling more cash through this dysfunctional system could arguably make things even worse by wasting future donor resources and in the process undermining constituencies for aid (see Myth #9).

Myth #8: The IFF will to help achieve the MDGs. No chance. In the proposal, it is explicitly claimed that the IFF “provides the additional resources necessary to help achieve the MDGs.”¹¹ It later warns that “without the additional resources the IFF could provide, we will fail to meet the MDGs.”¹² The implication is that the IFF is needed if the world is to reach the MDGs. Indeed, it is clear from the structure of the IFF that it was conceived and designed explicitly with the MDGs in mind. The end date of 2015 for IFF disbursements is the UN deadline for the MDGs to be reached. And the \$50 billion target of the IFF comes directly from a UN estimate of the additional annual aid required to meet the MDGs.¹³ Yet this figure (and those from similar costing exercises) makes several heroic assumptions, such as immediately better policies and management, which raise very real questions about whether financing is even the primary constraint. Even if the distinction is made that frontloading aid is necessary but not sufficient, this is nonetheless highly misleading.

This is because the MDGs will not be met by 2015, even if unlimited development assistance is made available. The rates of progress required by many of the goals are simply too ambitious

¹⁰ IMF (2004), “Review of the Fund’s Strategy on Overdue Financial Obligations,” IMF, Washington DC, August 13.

¹¹ HMT, IFF proposal, p. 3.

¹² *ibid*, p. 21.

¹³ United Nations (2001), “Report of the High-level Panel on Financing for Development”, Chaired by Ernesto Zedillo.

based on historical precedent.¹⁴ In many cases, poor African countries are being asked to achieve in a decade what took European countries many generations to accomplish. Sub-Saharan Africa, for example, is being asked to reach universal primary school completion by 2015 from a current level of around 57%. This leap took European countries over a century to achieve, but we are now expecting Africa to do it in just ten years. At the same time, empirical evidence suggests that money is far down the list of importance in determining education outcomes. History shows that, while aid is frequently helpful, there are very severe limits to the degree to which additional aid can contribute to accelerating development outcomes.

A popular version of this myth is that we can ‘double aid to halve poverty.’ This sounds good, but in practice it is utterly implausible. The global poverty headcount is in fact likely to be cut in half from its 1990 level by 2015, but aid will not be the reason. Credit goes to fast economic growth in India and China. The vast majority of countries will not halve poverty simply because the implied growth rates are too high. For the typical African country to halve poverty, for instance, it will need to grow on average at least 7% per year for the next 15 years—a feat reached by only five countries worldwide between 1985-2000. Actual African growth over this period has been just 2.4% and nearly half of Africa’s economies have had negative per capita growth, allowing the poverty ratio to actually increase from 47% in 1990 to 49% in 2000.

But couldn’t lots more aid delivered more efficiently help to accelerate growth rates? Most aid estimates that suggest so use the discredited ‘financing gap’ model, which has almost no link to reality. (As Bill Easterly has pointed out, if this approach did work, Zambia’s per capita income should be \$20,000, or 33 times the actual figure of about \$600.¹⁵) There are, of course, several very encouraging studies which show that aid does lead to economic growth in good policy environments and that certain kinds of assistance, such as aid for infrastructure, have strong short-term growth effects.¹⁶ But all of these studies also show very steep diminishing returns to additional aid, suggesting that piling in more aid quickly becomes ineffective.¹⁷ This is particularly the case since many countries thought to have ‘good policies’ are already donor favorites and receive substantial aid (see Myth #6). For many of the rest, which have weak policies and institutions, they probably cannot use more aid very effectively. Even if aid is spent efficiently, it is still unreasonable to expect that any amount will generate Asian tiger-like growth rates to halve poverty or cause any of the other MDGs to be reached.

Myth #9: There is no harm in trying. One of the purported selling points of the IFF is that it will “demonstrate the case for significantly higher aid flows.”¹⁸ This is a bold assumption that the promised targets, such as halving poverty, will be achieved. There are huge potential risks, both to future aid budgets and to the claims of aid effectiveness, of such a failure. If the \$50

¹⁴ See Michael Clemens, Charles Kenny, and Todd Moss (2004), “The Trouble with the MDGs,” CGD Working Paper 40, Center for Global Development, Washington DC, May.

¹⁵ William Easterly (2001), *The Elusive Quest for Growth*, MIT Press, Cambridge, p. 43

¹⁶ Craig Burnside and David Dollar (1997), “Aid, Policies, and Growth,” *American Economic Review*, Vol. 90, No.), pp. 847-868; Michael Clemens, Steve Radelet and Rikhil Bhavnani (2004), “Counting Chickens When they Hatch,” CGD Working Paper 44, Center for Global Development, Washington DC, July.

¹⁷ e.g., Paul Collier & David Dollar (2001), “Can the World Cut Poverty in Half? How Policy Reform and Effective Aid Can Meet International Development Goals,” *World Development*, Vol. 29, No. 11, pp. 1787-1802.

¹⁸ HMT, IFF powerpoint presentation.

billion is raised and the promised outcomes are not evident, then what kind of political environment will that leave behind? The inability to reach goals in the past has contributed to previous bouts of ‘aid fatigue’ and the fragile constituency for aid is highly vulnerable to counterclaims of aid as ‘money down a rathole.’ The IFF, by over-promising what aid can accomplish and frontloading the disbursements, could be setting up development aid for a major backlash just as the debt service obligations have to be approved. Imagine the response in the US Congress to paying for projects that are already known to have not lived up to their billing?

Myth #10: The IFF is an innovative use of private capital markets for development. Perhaps, but we can do much better. Private capital markets and their ability to find innovative solutions to risk, uncertainty, and specific financing needs, hold a lot of potential for improving the way aid works. The IFF captures some of these benefits, especially by using the bond markets to create a virtual pot of callable aid flows which allow more predictability. But it misses out on radically changing a dysfunctional aid system by foregoing some of the potential improvements that could make a real difference (see Myth #7).

Fortunately, there are many other ways of creatively applying private market solutions to development problems. The British government and the Global Alliance on Vaccines and Immunization (GAVI) are already joining forces to use advanced purchase agreements to overcome the market failure for steady vaccine supplies. Other possibilities can be imagined too. Risk management techniques could be applied to help poor countries better cope with the vulnerabilities they face. For instance, commodity futures could be utilized to insure coffee producers against unexpected declines in prices or to shock-proof debt service obligations. Financial innovation could also be employed to overcome shortcomings in the way aid is delivered. The short-term commitment cycle prevents the long-term planning and resources needed to tackle some problems, such as the fight against HIV/AIDS, or reliable financing for education incentive schemes. Annuity-type financial instruments, for example, could be created to price and guarantee such flows. The IFF therefore is not the last or only chance to use the power and ingenuity of the private capital markets. Even if the IFF itself never comes to fruition, it has certainly helped to spark a new round of creative thinking.

Conclusion

The IFF as currently proposed and promoted is shrouded in a number of misconceptions and based on several questionable assumptions. The proposal still has many details and issues to be finalized, but there are a number of reasons to be skeptical that this is the best way forward to improve the quality of aid or as a vehicle for ramping up aid flows over the next decade or so. Aspects of the IFF deserve further consideration, but the overall proposal is one that raises serious doubts, especially for donors outside the EU. Other options, including a more vigorous appeal for more aid through the normal budgetary processes and long-term constituency building, may be less exciting, but nonetheless more transparent, accountable, and democratic. As a catalyst for creative thinking and frank discussion about some of the ills of the international aid system, the IFF deserves approbation. As a real mechanism for raising development finance, it warrants more critical analysis and a healthy dose of skepticism.