Innovative Financing Tools to Address Infrastructure Challenges in Emerging Markets[1]

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Abstract: *The infrastructure investment gap in emerging markets poses significant challenges to economic and social development, with wide-ranging impacts. The urgency to address this gap has reached unprecedented levels.*

Traditional methods of infrastructure financing are no longer sufficient to meet current needs, especially given limited fiscal space. As a result, a variety of innovative financing tools have emerged to bridge this gap, including Public-Private Partnerships (PPP), credit enhancement, partial credit guarantees, construction insurance, political risk insurance, liquidity enhancement mechanisms, sustainability-linked loans/bonds, capital market solutions, blended finance, impact investing, and development finance institutions. These innovative tools and approaches represent a paradigm shift in infrastructure financing and offer promising avenues to close the infrastructure gap and help emerging markets unlock their full economic growth potential.

Multilateral development banks play a crucial role in narrowing the infrastructure gap in emerging markets. The long-term financing, concessional loans, technical assistance, and capacity-building support they provide are essential for facilitating project implementation. Expanding local currency financing is one of the key strategic goals of these development banks. Local currency financing, as a means of reducing exchange rate risks, enhancing financial stability, and supporting the development of domestic capital markets, serves as a powerful tool for addressing infrastructure financing challenges.

It is great pleasure to get an opportunity to address this prestigious gathering. The event follows NDB's successful 9th Annual Meeting held in Cape town. The theme of the Annual Meeting was 'Investing in a Sustainable Future' which flows seamlessly into the agenda of the Bund Summit 2024. Reforms, Opening Up, and Development are three key mutually reinforcing pillars that have under pinned economic advancement in many countries. Given the role of New Development Bank, I would like to approach the topic from an infrastructure investment point of view. I will touch upon three main areas:

- First, the consequences of infrastructure investment gap for economic and social development in emerging markets

- Second, the need for innovative financing instruments to finance infrastructure in emerging markets

1 The article is the keynote speech delivered by the author at the opening ceremony of the 6th Bund Summit Navigating a Changing World. The script was provided by the author, and the abstract was added by CF40 Secretariat.

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● Third, the role played by Multilateral Development Banks

I. The Impact of the Infrastructure Investment Gap on the Economic and Social Development of Emerging Markets

The imperative to address the infrastructure investment gap in emerging markets has never been more pressing. This critical issue is the bedrock of sustainable development, economic progress, and improved quality of life. It presents a complex challenge, but one that must be confronted with innovation.

The infrastructure investment gap in emerging markets poses a significant challenge to economic and social development, with wide-ranging consequences. The lack of reliable transportation networks, energy supply, communication systems hinder trade and investments, hampers productivity and stifles economic prospects. Businesses operating in regions with poor infrastructure face challenges competing globally due to higher operating costs and limited access to markets. This can discourage foreign investment and hinder job creation. Infrastructure gaps often exacerbate existing inequalities within emerging markets. Well-connected urban areas might thrive, while rural and marginalized communities remain underdeveloped due to a lack of basic infrastructure leading to widening the economic divide. It also hampers social development by impeding access to education, healthcare, and clean water directly impacting people's quality of life and overall human development. It exacerbates environmental challenges by promoting inefficient energy use and unsustainable practices. In essence, the infrastructure investment gap perpetuates a cycle of underdevelopment, leaving millions trapped in poverty and marginalization.

The global infrastructure investment gap is substantial, estimates ranging in trillions of dollars over several decades.

Financing in emerging markets presents unique challenges, often creating barriers to closing the infrastructure investment gap. Some common challenges include:

First, perceived risk in the form of policy or regulatory uncertainties that often deter investors. Exchange rate volatility is also a risk that impacts on the expected return of infrastructure projects. Project risks such as construction delays, cost overruns, or difficulties securing permits are just some to mention.

Second, weak institutional capacity such as lack of technical expertise, weak regulatory framework or weak governance are also to blame. Many emerging markets lack the technical and managerial expertise to properly plan, design, procure, and manage complex infrastructure projects.

Third, lack of deep and liquid domestic capital markets, making it difficult to mobilize long-term financing for infrastructure projects or Investors often demand higher returns due to perceived risks, leading to a higher cost of capital and making projects less financially viable.

Lastly, inadequate Project Preparation leading to a shortage of well-prepared and bankable projects. Many infrastructure projects in emerging markets lack proper feasibility studies, environmental impact assessments and financial modelling.

Bridging this gap requires a multi-faceted approach, concerted efforts from governments, international organizations, including increased public spending, innovative financing mechanisms, and private sector participation.

II. The Necessity of Providing Innovative Financing Tools for Infrastructure Financing in Emerging Markets

There are multiple pitfalls in traditional infrastructure financing instruments. Traditional infrastructure financing instruments, while having served their

purpose in the past, often present certain limitations in the context of emerging markets, and the evolving global landscape.

● Public funding, especially in emerging markets, may be insufficient to address the vast infrastructure needs. High levels of public debt, competing spending priorities, and limited revenue collection can constrain governments' ability to finance large-scale infrastructure projects.

● Traditional financing models, like bank loans and bonds, may lack the flexibility needed to address the unique challenges of infrastructure projects, such as long gestation periods and revenue uncertainty

● Private sector financing, while crucial, often comes at a higher cost due to perceived risks associated with emerging markets. This can make projects less financially viable or lead to higher user fees, potentially impacting affordability and access.

Given the global infrastructure investment gap, particularly acute in emerging markets and the limitations of traditional instruments, there is a need to move beyond traditional infrastructure financing mechanisms. The need for new and creative solutions is clear. Fortunately, a wave of innovation is transforming the landscape of infrastructure finance.

● Public-private partnership (PPPs) leverage private sector expertise and capital alongside public resources. By sharing risk and responsibilities, these collaborations facilitate the development and operation of large-scale projects that would otherwise not be financially viable or have risks which private sector alone would not be willing to take.

● Credit enhancements are a crucial tool to attract private investment for infrastructure projects, especially in emerging economies. These mechanisms help mitigate the risks associated with infrastructure development, making them more attractive to lenders and investors. Some key credit enhancements being used for infrastructure financing include:

Partial Credit Guarantees (PCGs) are provided by multilateral development banks or government agencies and cover a portion of the lender's potential losses in case of default. They enhance the project's credit rating, making it easier to access financing at favorable terms.

Construction Risk Insurance protects against cost overruns, delays, and performance issues during construction. It provides lenders and investors with greater assurance of project completion.

Political Risk Insurance covers risks like expropriation and currency inconvertibility, which can impact project viability. It enhances investor confidence, especially in politically volatile regions.

Liquidity Enhancement Facilities provide standby credit lines or guarantees to ensure timely debt servicing during periods of financial stress. They enhance project resilience and reduce the risk of default.

● Sustainability linked loans and bonds are innovative financial instruments that incentivize borrowers to achieve predetermined sustainability performance targets. Unlike green bonds that earmark proceeds for specific green projects, these instruments offer financial benefits, such as lower interest rates or coupon payments, if borrowers meet their sustainability goals. These goals can span various environmental, social, and governance (ESG) factors, including carbon emissions reduction, water conservation etc. This performance-based approach encourages companies to integrate sustainability into their core business strategy while providing investors with greater transparency and impact measurement. Their growing popularity reflects a shift towards sustainable finance, where capital allocation is aligned with achieving a positive impact on the planet and society.

● Some of the capital market innovations and solutions include:

Infrastructure Debt Funds are dedicated funds that invest in debt instruments of infrastructure

projects. Their participation can enhance project creditworthiness and attract other investors.

Subordinated Debt is a form of debt with lower priority in repayment compared to senior debt. It acts as a cushion for senior lenders, reducing their risk exposure.

● Blended finance is an innovative approach to financing development and impact projects, combining concessional capital from public or philanthropic sources with commercial investments. It aims to de-risk projects and attract private sector capital to areas that traditionally struggle to secure funding due to high risks or low returns.

● Meanwhile impact investors target both financial returns and positive social or environmental impacts. Infrastructure projects aligned with their objectives, such as clean water or affordable housing, can attract this type of capital.

● Development Finance Institutions & MDBs provide crucial funding and technical assistance for infrastructure projects in developing countries. Their expertise and risk mitigation strategies are essential for mobilizing private capital in challenging environments.

These innovative instruments and approaches represent a paradigm shift in infrastructure financing and offer promising pathways to bridge the infrastructure gap and enable emerging markets to unlock their full potential for economic growth.

III. The Role of Multilateral Development Banks

Multilateral Development Banks such as World Bank, Asian Infrastructure Investment Bank, New Development Bank etc. can play a more catalytic role in bridging the infrastructure gap especially in emerging markets.

MDBs provide a critical source of long-term financing for infrastructure projects, particularly in emerging markets where access to capital can be limited. Their concessional loans, grants, and guarantees help de-risk investments and also attract private sector participation. MDBs bring a wealth of technical expertise and knowledge to the table, helping to design and implement infrastructure projects that are sustainable, resilient, and inclusive. They also support capacity building and institutional strengthening, ensuring necessary skills and resources to manage infrastructure effectively. While MDBs have made significant contributions to infrastructure development, there is still much more that can be done to maximize their impact. Recognizing this need, G-20 has commissioned two reports over the course of the past three years- the Capital Adequacy Framework (CAF) review of Multilateral Development Banks (MDBs) and the Triple Agenda report. These two reports, while distinct in their focus, converge on a shared vision: empowering MDBs to play a more impactful role in financing sustainable development.

The G20 Capital Adequacy Framework (CAF) review of MDBs report, officially titled "Boosting MDBs' Investing Capacity," is a landmark document that has the potential to significantly enhance the lending capacity. The report provides a comprehensive set of recommendations aimed at optimizing the capital adequacy frameworks of MDBs. Some of the key recommendations include, relook at the risk appetite, use of innovative financing mechanisms, such as blended finance and guarantees, hybrid capital, credit enhancements, use of callable capital in the capital adequacy frameworks, greater collaboration and coordination among MDBs, to enhance the overall effectiveness of the MDB system. The recommendations of the CAF review report have the potential to significantly increase the lending capacity of MDBs as well as enable MDBs to mobilize private capital to bridge the infrastructure gap.

The Triple Agenda Report, prepared by an Independent Expert Group (IEG) co-convened by Lawrence Summers and N.K. Singh lays out a roadmap for MDBs to become more effective, responsive, and impactful in promoting sustainable development and inclusive growth. The report calls for MDBs to significantly scale up their sustainable lending by 2030 to address the massive financing needs for achieving the Sustainable

Development Goals (SDGs) and the Paris Agreement on climate change. This will require MDBs to optimize their balance sheets, leverage private sector capital, and explore innovative financing mechanisms.

The G20's focus on the CAF review and the Triple Agenda report demonstrates a commitment to strengthening the MDB ecosystem and harnessing its potential to address global challenges of infrastructure gap in emerging markets.

No discussion about infrastructure financing can be complete without touching on the topic of Local Currency Financing. Local currency financing for infrastructure projects involves raising funds in the domestic currency of the country where the project is located. This approach offers several key advantages over traditional financing methods that rely on foreign currencies, especially in emerging markets:

● Borrowing in local currency eliminates the risk of exchange rate fluctuations that can significantly impact project costs and financial viability, especially during periods of currency depreciation.

● By reducing reliance on foreign currency debt, local currency financing helps protect projects from external shocks and financial crises.

● Issuing local currency bonds and other instruments for infrastructure projects promotes the development and deepening of domestic capital markets

While local currency financing offers many benefits, it also presents certain challenges such as:

● Limited investor appetite for EM local currency bonds due to concerns about currency volatility or lack of liquidity in the market

● The availability of long-term local currency financing might be constrained, making it challenging to match the long-term nature of infrastructure projects.

A combination of hard and local currency financing to match the cashflow profile of the project could mitigate exchange rate risk.

Local currency financing is not a solution for all infrastructure financing challenges, but it offers a powerful tool, in spite of some of its challenges.

We at New Development Bank have emphasized the importance of local currency financing in our operations and have explicitly stated that expanding local currency financing is one of our key strategic objectives. During the 2022-2026 strategy period NDB aims to provide 30% of its total financing in the local currencies of its member countries. As of today we have financed projects in CNY, ZAR in our member countries and are in process of expanding our local currency financing options in INR and BRL.

NDB today is one of the largest issuer of Panda bonds in the China Interbank Bond Market. Since 2016 till date, we have issued CNY 55.5 billion Panda bonds. These proceeds have been used to finance CNY denominated projects in China. We are also currently in the process of exploring to offer CNY denominated loans to projects in other member countries where there could be CNY exposure on projects.

In conclusion, the journey of reforms, opening up, and development is intrinsically tied to the robust financing of infrastructure. By embracing innovative financing solutions, fostering collaboration between public and private sectors, and leveraging the expertise of multilateral development banks, we can mobilize the resources needed to build sustainable and inclusive infrastructure. The path forward requires a collective commitment to reform, openness, and development. It demands that we embrace new ideas, challenge traditional approaches, and work together to unlock the vast potential of infrastructure investment.