RIS Policy Brief

No. 107 October 2021

Time to Reform Lines of Credit

Striving for Efficiency & Effectiveness

Rationale

Development cooperation landscape has changed radically over the years with emergence of Southern donors especially the BRICS countries and widespread recognition and adoption of South-South Cooperation (SSC) and Triangular Cooperation (TrC) models. Developing countries are more willing to engage in these formats of cooperation that promote the spirit of partnership and mutual benefits than dependence on aid providers. India has been embracing SSC and TrC for a very long period with partners in South Asia, Africa and Latin America. At the same time, the nature and scope of development cooperation has changed over the years following higher economic growth, trade and investment in developing economies and emerging markets. The official development assistance from OECD and other donor countries are neither viewed adequate nor found effective in addressing all types of developmental concerns in the recipient countries. The role of private capital, in fact private sector involvement as a whole, is increasingly being recognized for making desired economic and societal changes in the developing and less developed economies.

Time has come to view development assistance, regardless of its form and magnitude, as part the development capital, both involving public and private sector. Businesses and responsible social enterprises constituting the private sector or civil society can play much bigger role in the development process along with official development assistance. In other words, it necessitates pooling of non-sovereign sources of funding for development cooperation projects, and for business and enterprise promotion in partner countries. Unlike official development assistance which often manifests in the form of technology transfer, capacity building, social infrastructure e.g. health & education, humanitarian assistance, etc, development capital would include investing in project preparation, handholding of domestic firms in host countries, etc. Public-Private Partnership (PPP) structure is preferred by the host countries to bring in private capital. However, there is dearth of such bankable PPP projects due to high early stage project development risks, which many private sector investors are not willing to take.

It is generally observed that effective project preparation often requires upwards of 3-5 per cent of the total project cost - sometimes going as high as 10 per cent. Since this is perceived as the riskiest phase of project preparation, the unavailability of such funds prevents bankable projects coming to the market.

RIS *Policy Briefs* are prepared on specific policy issues for the policymakers. This Policy Brief has been prepared by a RIS Team led by Professor Sachin Chaturvedi, Director General, RIS including Mr Rajeev Kher, Distinguished Fellow, RIS and Dr Priyadarshi Dash, Associate Professor, RIS with expert drawn from consultations held with Mr Paritosh Gupta, CEO, Kukuza Project Development Company; Mr Kapil Kapoor, Former Director, Strategy and Operational Policies, African Development Bank; and Mr David Rasquinha, Former Managing Director, Export-Import Bank of India. Usual disclaimers apply.

Non-Sovereign Fund- A Holistic Approach beyond Lines of Credit

Line of Credit (LoC) is the widely used instrument for development cooperation. India has relied on LoC for its development cooperation activities in other countries. Most of these LoCs are extended through the Export-Import Bank of India (EXIM Bank). India's development cooperation support to Afghanistan, Nepal, Maldives and African countries have increased significantly in recent years. In fact, India's development cooperation efforts in Africa have diversified including several Lines of Credit (LoC), technical assistance, human resource sharing, and other forms of project support. Currently, 189 projects amounting to US$11.4 billion are being implemented in 42 countries in Africa. In addition, 38 countries in Africa are benefitting from India's Duty Free Tariff Preference (DFTP) scheme. In addition, the India-Africa Forum Summit (IAFS) has become an institutionalized mechanism for fostering comprehensive relationship between India and the African countries. Although LoCs are meant for specific purposes in the partner countries, it is not really enough to meet the larger development aspirations of those countries. Moreover, most of these countries have almost reached the threshold set by IMF in sovereign borrowings, thus limiting their new LoC exposures.

Globally it is seen that countries have sovereign and non-sovereign windows for promoting infrastructure financing abroad and both have its place. For instance, DEG and KfW in Germany JICA and JBIC in Japan, UKEF and CDC in UK, AFD and lines of credit window in France, IFC and World Bank and Private sector windows of ADB and AfDB, etc. are some of the examples of co-existence of both sovereign and non-sovereign sources of funding. Now that India intends to play an active role in financing infrastructure in the African continent, South East Asia, etc. it is high time that India too brings in such a non-sovereign window to impart greater flexibility in its operations.

No doubt, it is to be recognized that the Line of Credit still has its place as many mega infrastructure projects can only make money on an operation basis and cannot afford to amortize the capital costs in projects such as ports, railway infrastructure etc. Hence such projects need to be structured as hybrids – Build Operate and Transfer (BOT) plus Line of Credit.

Moreover, the formats and instruments of development cooperation need to change involving comprehensive economic partnership components than merely LoC, capacity building and technical assistance. For example, along with India's unilateral measures towards Africa, the African countries themselves are showing willingness for deeper bilateral economic relations with India. Besides domestic motives for enhancing the level of bilateral and regional relations in India and partner African countries, there are several common grounds that inspire both sides for a deeper and comprehensive economic partnership.

As mentioned above, sovereign sources have been the major traditional sources of development cooperation. However, with increasing demand for funding support in several countries and complex socio-economic interplay of forces, development cooperation with public funding cannot be adequate and viable in the long-run. There is very strong appetite in the private sector for investment even in social sector projects. In nutshell, there is a need for non-sovereign fund to supplement the development cooperation initiatives of India.

Structure and Components of the India International Development Fund

The Fund would have the following four components of utilization which are mutually reinforcing and efficient.

Project Prepation Fund for Infrastructure

It is observed that major problem being faced in bridging huge infrastructure gap in Africa is not finance but lack of bankable infrastructure projects due to poor project preparatory exercise. Developing infrastructure is capital intensive. Africa's annual infrastructure funding needs have been estimated at over US$ 100 billion. This cannot be met entirely by the public sector, yet infrastructure projects struggle to mobilize private sector investors, especially during the earliest stages of project development. A detailed project development exercise at the initial stage itself, therefore, ensures that the project is well-structured with better risk-reward sharing framework before implementation and all necessary clearances, financial commitments, etc. are in place thereby eliminating ambiguity. The initial stages of project development require relatively limited finance, but higher risks can deter private sector investors.

To address these challenges, a need is also being voiced at various fora by the stakeholders for an integrated project development agency (as distinct from consultants) to coordinate and integrate the project development/ financing from concept to completion, including assistance to (i) develop a pipeline of bankable infrastructure projects, (ii) accelerate private investment into African infrastructure; (iii) coordinate and integrate progress with all the stakeholders; and (iv) mobilize public and private sector funding. It is felt desirable that the project development agency should have a strong India connect in terms of their shareholding so that it has the necessary understanding and networks for promoting Indian project exports to Africa.

The main objectives of the Project Preparation Fund (PPF) would, therefore, be to provide necessary comprehensive project development support and hand-holding to Indian firms for promoting project exports to Africa, South Asia and Latin America. The PPF can begin its operations with an initial seed money contribution and subsequently it can mobilize funding from multilateral and bilateral agencies and other interested investors. In line with the broader vision of engagement with Africa and the vision of Agenda 2063, the PPF would have short-, medium- and long-term vision for promotion of investment in infrastructure, keeping in view the strategic interests of India, and the Indian public and private sector entities operating in the African Continent, including in resource-based industries and other sectors of interest. The most competitive Indian firms can be identified with transparent bidding and tendering process. In addition to Greenfield projects, the Fund may take up some incomplete projects and prepare future timelines for the project execution. To become the leading strategic investor in commercially viable and financially attractive PPP infrastructure projects, the Fund may build an investment ecosystem in Africa with support from leading Indian firms.

Seed Capital to Business Enterprises

Political and macroeconomic risk is one of the biggest deterrents for investors in the African infrastructure. Many Indian investors just do not invest because of this risk especially in countries with political instability, civil war, etc in number of sectors including oil, coal, minerals, etc.

In this regard, a more successful innovation has been the seed-funding of market makers in hedging instruments. An example of a successful model in this regard is TCX, which offers hedging products in emerging-market currencies and the IIDF possibly can set aside a portion of the fund to address political, repatriation and other currency-related risks, to the Indian private sector investing in Africa. By doing so, India can achieve several goals in one stone such as expanding country's footprint in Africa, Latin America and other continents on favourable conditions, promote investments that would induce exports and strengthen economic relations between India and the concerned host country.

Support to Social Enterprises

Social enterprises are new innovations in development finance landscape. Unlike pure non-profit organizations, social enterprises make a judicious use of profit-making with social causes. These firms promote income-generating activities for addressing numerous social and developmental concerns in the developing and less developed countries. However, unlike the typical profit-making business enterprises that solely emphasize on making profits social enterprises rather focus on maximizing the corpus of funding to support the larger social cause. These innovative ventures despite credible potential for creating desirable social and economic impacts in the host countries may be commercially less attractive for investment. IIDF can provide handholding to select performing Indian social enterprises to operate in other countries as well. Besides making immediate economic impact these enterprises can facilitate development partnership between India and partner countries.

Support to Strategic Initiatives

With comfortable stock of foreign exchange reserves and reasonably high growth in the 2000s, India has become a creditor country and support promotion of Southern models of development cooperation in the form of South-South Cooperation (SSC) and Triangular Cooperation (TrC). At the same time, India needs to spread its soft power for forging mutually-beneficial collaborations and partnerships in the strategic space. IIDF can support partner countries in times of crisis such as natural disasters (Nepal), political and humanitarian crises (Maldives, Afghanistan), for building social infrastructure (Kenya, Madagascar), comprehensive continental economic partnership like Asia Africa Growth Corridor (AAGC), among others. 'Neighbourhood First', 'Look East Policy', 'Focus Africa', 'Free Open and Inclusive Indo-Pacific' could be the governing frameworks for implementing projects of strategic importance for India in other developing countries, less developed countries, and small island developing states.

Africa as a Priority Region for IIDF

India-Africa relations have improved considerably in the recent years with intensification of diplomatic and economic engagements between India and several African countries led by the Hon'ble Prime Minister of India Shri Narendra Modi. The 23 by India leaders visits to Africa at the level of President, Vice President and Prime Minister during 2014-2018 and the commitment to open18 new Indian Missions in Africa over the period 2018-2021 reflect this renewed focus. During visit to Uganda in July 2018, Prime Minister Modi had underlined the 10 Guiding Principles for intensifying and deepening engagement with Africa which could form the basis for the future trade and investment relations between India and Africa. Endowed with rich natural resources, large young population and diverse democratic and cultural traditions, both India and Africa offer vast market access. In addition, both the regions possess tremendous growth potential in several sectors of the economy which would trigger global economic growth as the advanced economies continues to face prolonged economic stagnation.

India's trade and investment relations with Africa have improved over time suggesting the scope for much deeper and comprehensive economic relations in the future. Exports and imports to/from India to the region have grown by the compound annual growth rate of 4.7 per cent and 3.2 per cent respectively during 2010-11 to 2018-19. In 2018-19, the level of Indian exports to and imports from Africa were US$28.5 billion and US$41.1 billion respectively marking an increase of approximately US$10 billion each for exports and imports compared to 2010. Likewise, foreign direct investments by India in the East African countries such as Burundi, Ethiopia, Kenya, Rwanda, Tanzania and Uganda were US$416 million during April 1996 to December 2016. India is now the fifth largest investor in Africa. During 2014-2018, India had 134 projects in Africa with US$5.403 billion capital investment and 30, 334 jobs.

Deeper and diversified trade and investment flows could be a game changer for both India and the African countries in the future. India has always viewed the African countries as trusted development partners for promoting mutually beneficial trade and investment. Through its 'Focus Africa' programme and other bilateral trade arrangements Africa has assumed renewed emphasis in India' trade policy for past several years. At the same time, Africa has embarked on the region-wide trade integration by signing the African Continental Free Trade Agreement (AfCFTA) which not only paves the way for deeper intra-regional trade in the region but also opens avenues for India to expand the scope of its trade engagement. While market access for trade in goods and services is gradually improving as bilateral negotiations progress, Indian investments in Africa is still much below the potential that exists in the region. With suitable hand-holding of Indian firms and investment facilitation support in host countries, export-promoting investments by India can be scaled up. Some leading business houses are already operating in Africa and are keen to invest more countries in Africa. However, in general, Indian firms perceive investments in Africa as high-risk and uncertain ventures given political instability, security risks and information gaps.

Given the greater willingness on both sides, market access would continue to improve as tariff rates become lower gradually and non-tariff measures streamlined. However, some other impediments especially trade facilitation gaps, lack of proper awareness and marketing of products, lack of market infrastructure, low export-orientation of investments and high perceived risks affect trade between India and the African countries. There is need for building congenial environment for Indian investments in Africa by various incentives, seed capital and institutional support. India's outward investments in resources sectors would contribute to local production in the host countries and enable exports to third countries in Africa and other regions as well. In Post-AfCFTA period, the African countries may harmonize their trade policies in the areas of tariff, non-tariff measures, standards & certification, trade facilitation and other policy fronts. India can explore augmenting its trade with Africa by following a unified approach and offering innovative funding and incentive schemes to Indian firms operating in Africa or prospective investors.

Operationalisation of IIDF in Africa

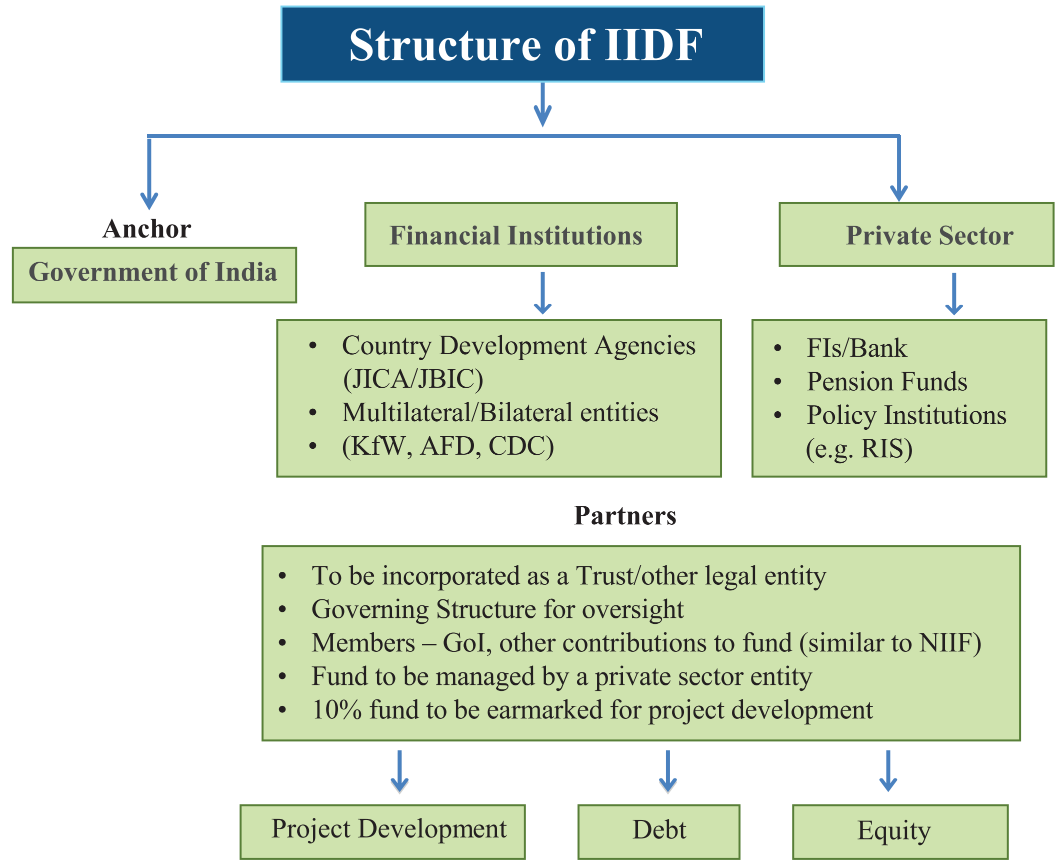
Taking into account the strong complementarity for deeper economic relations between India and Africa, IIDF may begin its operations in Africa.

The IIDF may be utilised for:

- Early stage risk capital to develop projects i.e Project Preparation Fund (say 10 per cent of the total corpus)
- Project development support to the government and private investors
- Equity and quasi-equity in bankable projects
- Longer-term infrastructure debt
- A portion of the fund could be earmarked for providing political and macroeconomic risk mitigation instruments (Seed Capital)

Possible Selection Criteria of projects for funding could include:

- Public-private partnerships and private projects with good cash flow predictability;
- Strong sponsor with solid technical and financial track record;
- Should provide adequate return commensurate with the risk profile of the project;



Source: Authors' compilation.

- Should have significant development impact; and
- Equator Principles for managing environmental and social risk in project finance.

Way Forward

The future of development cooperation rests with the innovative models of partnership based on the principles of South-South and Triangular cooperation. This narrative suggests pooling resources than merely building dependence on certain forms of development assistance. IIDF would be a new-generation development agency by India to inspire such a transition in the development cooperation landscape. Besides Lines of Credit which has been a reliable instrument of support to Indian firms operating in other countries, IIDF envisages an integrated and holistic scheme of development partnership that includes components like seed capital, risk coverage, project preparation fund, innovative blending of public and private instruments of funding, hand holding and alignment with local development aspirations.

— Policy research to shape the international development agenda —

RIS Reports, Discussion Papers, Policy Briefs, New Asia Monitor, Occassional Papers and *RIS Diary* are available at RIS Website: www.ris.org.in

RIS
Research and Information System for Developing Countries
विकासशील देशों की अनुसंधान एवं सूचना प्रणाली

Core IV-B, Fourth Floor
India Habitat Centre
Lodhi Road, New Delhi-110 003, India.
Tel. 91-11-24682177-80
Fax: 91-11-24682173-74-75
Email: dgoffice@ris.org.in
Website: www.ris.org.in