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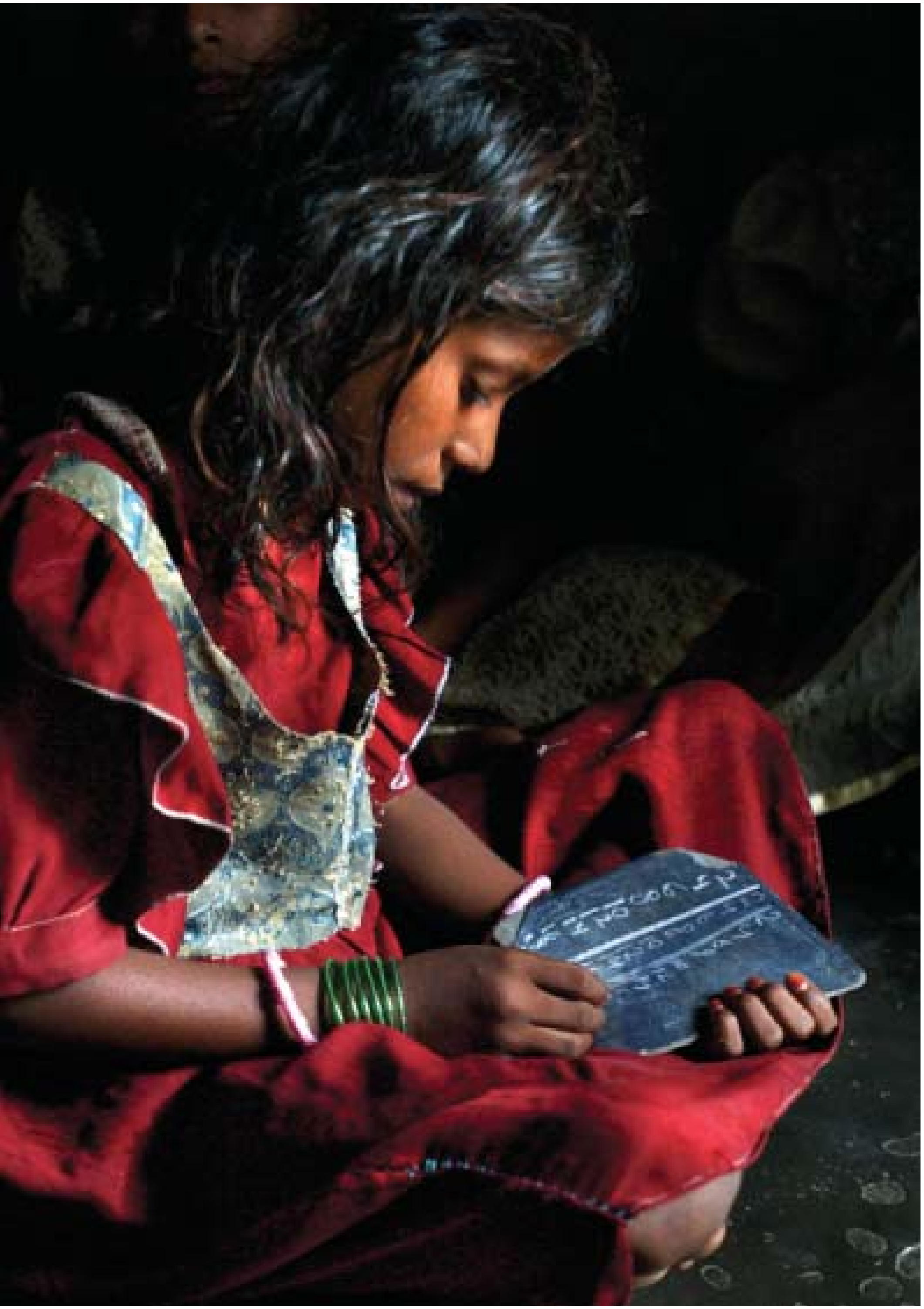
The International Finance Facility

IFF
INTERNATIONAL FINANCE FACILITY



Executive summary

Five years ago, in signing the Millennium Declaration, every world leader made a clear commitment to ending extreme poverty and meeting the eight Millennium Development Goals (MDGs) by 2015 – including halving extreme poverty, getting every child into school and reducing child mortality by two-thirds.

Although progress has been made, it has been uneven and slow, and at current rates, the MDGs will not be met in several parts of the world. It is already clear that the first interim target, to eliminate gender disparity in education by 2005, is going to be missed. Two million people each year die unnecessarily from tuberculosis and one million from malaria, while 40 million are currently living with HIV/AIDS. Twenty-five million children will lose one or both parents to HIV/AIDS by 2010. On current trends, it will take until 2165 to decrease child mortality by two-thirds in sub-Saharan Africa.

The UK Government is committed to increasing aid, cancelling debt and making trade work for all, but aid remains vital. Estimates suggest that the poorest countries in the world need an increase in aid of at least $50 billion a year if the MDGs are to be met.

The confirmation by the G8 in July 2005 that international donors will provide an additional $50 billion a year by 2010, compared with 2004, is an important step towards this. However, traditional increases in donor aid budgets will not be enough to provide these additional resources and meet the aid targets that have been set. Innovative financing mechanisms are needed to help deliver and bring forward the financing urgently needed to achieve the MDGs.

Based on donors' legally binding, long-term commitments, the IFF will leverage money from international capital markets by issuing bonds. Bondholders will be repaid from future donor payment streams. Pledges made by donor countries will not score on balance sheets until donors make actual cash payments to the IFF. The International Finance Facility (IFF) is a mechanism that will specifically support these efforts to bring forward donor commitments. Using existing and new resources, the IFF will be able to increase aid to the levels required to achieve the MDGs.

There is a strong moral case for bringing forward these additional resources. It is necessary to act now, or risk losing another generation to poverty. In some African countries, teachers are dying from

Aid works: developing country views

'To complement domestic efforts for development, developing countries need a critical mass of additional, harmonized, flexible and predictable development assistance, and sustainable investment in the medium to long term... Ministers strongly believe that there is substantial capacity for absorbing additional resources at both country and regional levels.'

Statement from Finance Ministers of emerging market economies and developing countries, Ministerial Forum on Financing for Development, 8 April 2004

HIV/AIDS faster than they can be trained. But there is also a compelling economic case. By frontloading aid, the IFF will be able to deploy a critical mass of aid when it will have the most impact. The economic and social returns of frontloading aid in key sectors can be very high; money spent now can tackle the root cause of current difficulties, and so dramatically reduce the build-up of expensive problems in the future. For example, the economic rates of return from infrastructure projects in low-income countries are estimated to be 30–40% for telecommunications, over 40% for electricity and over 80% for roads.

Finance from the IFF will support country-owned poverty reduction strategies, ensuring that aid is used to finance the key investments to put countries on a sustainable and lasting path to poverty reduction, prosperity and participation in the world economy. The primary responsibility for reducing poverty and achieving the MDGs lies with developing countries. Developing countries know that it is important that

they put in place the right policies to drive economic growth and attract investment. They need to decide, plan and sequence their economic policies to fit with their own development strategies. But even with all these policies in place, the poorest countries in the world will not be able to meet the MDGs without supportive international action on aid, debt and trade.

The IFF is building real momentum and has received support from more than 80 developing and developed countries, as well as from faith leaders, the business community and non-governmental organisations (NGOs).

IFF borrowing

Borrowing to invest is a well established domestic and development principle. All donor countries borrow to invest in their own future prosperity, as well as for delivering aid to other countries. The World Bank and International Monetary Fund (IMF) are also long-standing borrowers in the capital markets. To justify the IFF's borrowing, it must pass two economic tests. Firstly, it must meet the sustainable investment principles of the donor country, whereby the rate of return on the investment must be greater than the donor country's target rate of return and greater than the cost of the borrowing needed to bring forward the investment resources. Secondly, because the resources would be invested in recipient countries, the rate of return must also be greater than recipient countries' own target rates of return for public investment. The IFF would pass both these tests. Provided donor commitments are legally binding, and the risk of the high-level financing conditions being breached is sufficiently low, the IFF will be able to borrow at yields close to those of other international organisations, such as the World Bank. The target rate of return for public investment in developing countries varies between countries but tends to be around 8%. Project and programme investments in the poorest countries deliver much higher returns than both these tests. Evaluations of World Bank projects show average annual rates of return of around 25%.

How it would work

The IFF is a financing mechanism, not a new development bank or disbursement agency. It will not seek to become a new body for disbursing aid with new criteria that developing countries will need to meet, and would not establish a new aid bureaucracy. It would disburse aid using existing mechanisms that have been tried, tested and shown to be effective. Chart 1 is an overview of the IFF structure.

IFF income would consist of annual payments from donors. At regular intervals, perhaps every three to five years, donors would pledge 15-year streams of annual payments to the IFF. These regular 'pledging rounds' would build up a pattern of overlapping streams of payments to the IFF. Donors would make repayments over the longer term. Chart 2 illustrates the frontloading effect of the IFF.

These donor pledges would be legally binding, subject to one or more high-level financing conditions. Failure by a donor at any time to make any of the payments in a 'stream' to which it was committed would be viewed by financial markets as a sovereign default.

Donors would be 'severally' (i.e. individually) liable for making their payments to the IFF. They would not have any responsibility to make additional payments if another donor had defaulted and failed to make a payment as originally pledged.

High-level financing conditionality

Donor pledges would be subject to recipient countries meeting one or more conditions of good governance, breach of which would make it impossible for the donor to continue to make the committed annual payments to the IFF in respect of that recipient. For example, as with the IFF for Immunisation, avoidance of prolonged IMF arrears could be one suitable financing condition, being clearly defined and capable of independent determination for the purpose of risk analysis.

Financing costs

It is important that the IFF minimises the costs of leveraging in funds from the international capital markets. This means securing the highest possible rating for IFF bonds. Discussions with the financial community have indicated that, subject to the underlying credit quality of donor commitments, the IFF could obtain the highest AAA credit rating. This would mean that the IFF could borrow cost-effectively and on similar terms to other multilateral agencies such as the World Bank, and bilateral donors.

Disbursement

The IFF would seek to disburse its funds through existing effective bilateral and multilateral mechanisms. Funds would be allocated according to a set of high-level principles, which would help to ensure the effectiveness of aid financed through the IFF. These principles could include providing resources as predictable and untied grants and focusing them on poverty reduction in low-income countries.

The detailed mechanics of how disbursement decisions are made will depend on the IFF's governance structure. Both this structure, and the high-level principles, will be for agreement through consultation with donors, recipient countries and the wider development community at the establishment of the IFF.

Chart 1: Overview of the IFF

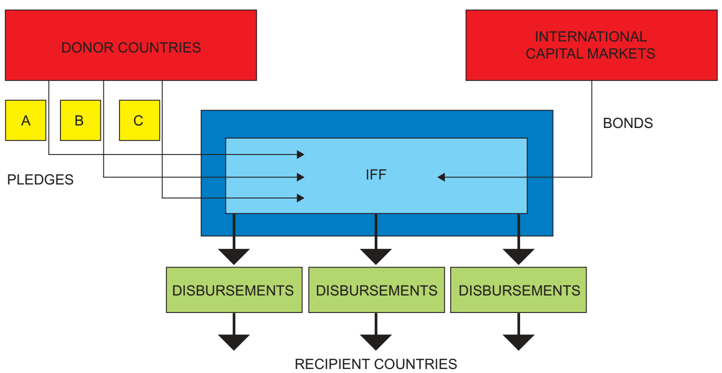
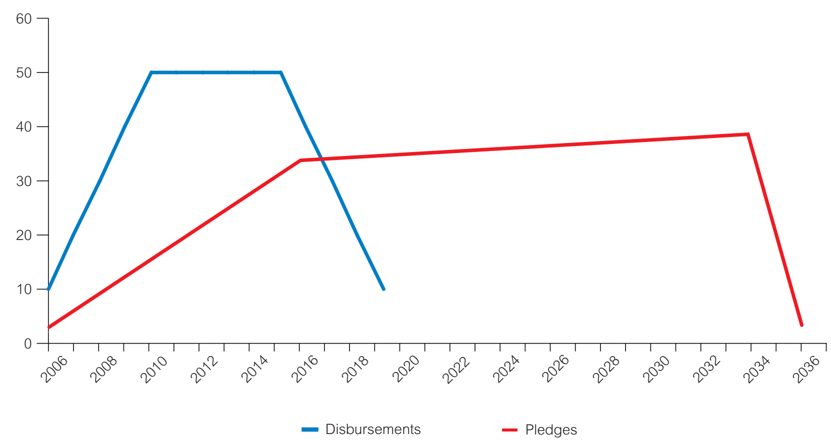


Chart 2: Illustrative diagram of disbursements and pledges – Global IFF $billion



Making aid work better

The IFF would not only increase aid flows to the poorest countries in the short term, but could also help to improve the way aid actually works. In the past, aid has not always been targeted or used effectively. But examples like Uganda – where extreme poverty has been reduced by 20% in the last decade – show how aid can work well in the right circumstances, where countries are committed to sustainable economic growth and poverty reduction.

Donors need to co-ordinate their aid so that developing countries do not have to deal with the huge administrative burden of reporting to numerous donors. The IFF could improve donor co-ordination and harmonisation, and target aid towards the specific purpose of achieving the MDGs. Furthermore, to work best, aid needs to go to the poorest countries and people, and on a long-term, predictable basis, that allows countries to effectively plan how best to spend resources. The long-term, multi-year commitments that donors would make to the IFF, according to an agreed set of high-level principles to ensure aid effectiveness, would increase the predictability and stability of aid, allowing recipient countries to make sustainable investments in their futures.

IFF high-level aid principles

High-level principles to ensure aid effectiveness might include:

Aid to be invested in poverty reduction. Finance from the IFF should be used in support of countries' poverty reduction plans, making key investments to put countries on a sustainable and lasting path to poverty reduction, prosperity and participation in the world economy.

Aid to be untied to contracts using suppliers from the donor country. Untying aid can increase the value for money achieved from aid by up to 20% and it can boost skilled labour markets with direct and positive spill-over for the private sector.

Aid to be provided in predictable multi-year programmes lasting at least three years. To tackle the causes rather than the symptoms of poverty, aid commitments must last into the medium term. Unpredictable aid flows make macroeconomic management difficult and add uncertainty to already shock-prone economies.

Aid to be disbursed in grant form. The poverty of many of the countries struggling to meet the development goals and the need to avoid an unsustainable burden of debt mean that the bulk of the IFF's funds should be disbursed as grants.

Aid to be disbursed to a wide range of countries committed to poverty reduction. This would ensure that a range of countries benefit and also that the IFF receives the highest possible credit ratings for its bonds and could improve the global allocation of aid resources.

Aid to be targeted at low-income countries. There is too high a proportion of aid going to countries that have relatively high income levels. For example, in 2001, aid per poor person was $675 in the Middle East and North Africa, compared with only $13 per poor person in South Asia.

IFF resources should support country-owned poverty reduction strategies, financing the key investments needed to put countries on a sustainable and lasting path to poverty reduction, prosperity and participation in the world economy. Developing countries need to decide, plan and sequence their economic policies to fit with their own development strategies. Recipient countries would be expected to show strong progress and results against these strategies. To maintain confidence, developing countries need to show that they can use aid to tackle poverty effectively through improving public financial management and increasing efforts to fight corruption.

Aid works: Rwanda Revenue Authority

Rwanda is recovering from a devastating genocide and civil war in 1994 in which more than 10% of the population is believed to have died. Around half of the national budget is now financed through aid.

With donor support, the Rwanda Revenue Authority was established in 1998 to overcome existing administrative bureaucracies, an absence of professional staff and corruption. Faced with a very low tax base (due to a large subsistence agriculture sector), there has been considerable focus on improving tax administration.

Improvements in revenue performance have been remarkable. Domestic revenue increased by 42% between 1999 and 2002, increasing the share of revenue in GDP from 10% to 13%.

DFID

Aid absorption

There is good evidence to show that the countries needing the most support to meet the MDGs have the capacity to absorb much higher levels of aid. The World Bank has estimated that countries in Asia and sub-Saharan Africa could effectively manage at least a 60–100% increase in aid flows in the short term. The World Bank has also estimated that, of the 65 countries unlikely to meet the poverty goal without further external assistance and/or policy changes, 43 could effectively absorb more aid today. Where absorptive capacity constraints do exist, these can often be addressed relatively quickly and simply when there is the incentive and policy framework to do so. The assurance of predictable and increasing aid flows can itself provide the incentive to address constraints.

Returns from aid can stay high as aid increases. Economic theory predicts that the marginal benefits of aid reduce as the amount of aid increases, but studies indicate that diminishing returns are very dependent on how aid is managed and rarely set in before aid reaches 25–50% of GDP. In many cases, declining returns are caused by unpredictable aid flows causing macroeconomic volatility.

In Mozambique, net resource flows more than doubled between 1996 and 2001, and aid as a proportion of GDP reached 40%. Growth has averaged between 7 and 8% over the last five years, while inflation has remained low, and poverty has declined by 15% since 1996. And in Vietnam, economic growth – supported by aid – has contributed to a halving of poverty in the past 15 years, and a two-thirds reduction in child mortality.

Of course, not all developing country governments will be able to plan for and use large new increases in aid immediately, and some will face capacity constraints in the public sector. That is why the IFF would phase in aid flows gradually, and why donors must help governments to improve their systems. In many cases, institutional capacity responds quickly and effectively to increased flows of finance.

The benefits of frontloading

Frontloading can help to improve the effectiveness of aid. By frontloading aid, the IFF will be able to deploy a critical mass of aid when it will have the most impact on reducing poverty, which means that the benefits of investing early easily outweigh the borrowing costs. The World Bank estimates that average returns to its aid programmes are around 25%, in comparison with annual borrowing costs of around 5%.

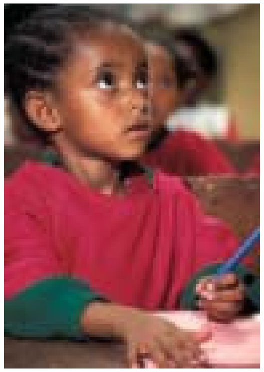
Frontloading creates economies of scale and allows the benefits of early intervention. The economic and social returns of frontloading aid in key sectors can be very high; money spent now can tackle the root cause of current difficulties, and so dramatically reduce the build-up of expensive problems in the future.

One of the strongest cases for frontloading is that it allows investment across a range of sectors at the same time, the results of which are reinforcing. For example, investing in water supports outcomes in health and education. However, the arguments for frontloading investment in individual sectors are also very strong.

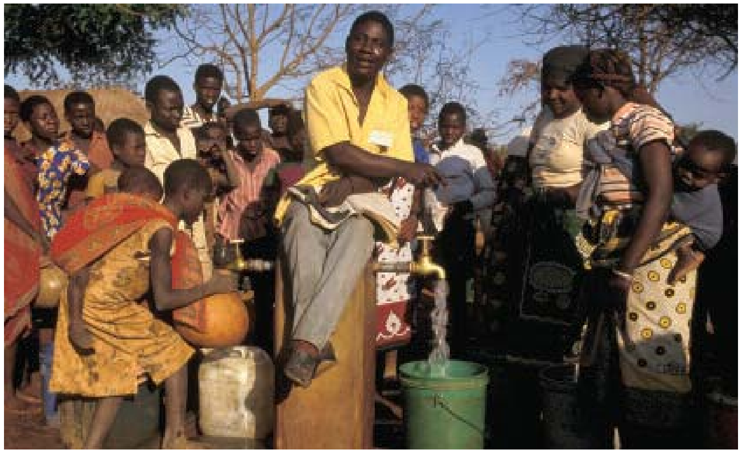
In the fight against **AIDS**, **tuberculosis and malaria**, there are three key benefits of frontloading: (i) timing – the resources to fight the three diseases would be made available more quickly, helping to curtail their spread and reducing mortality among those already infected; (ii) scale – the volume of aid made available through frontloading would allow an integrated approach of treatment and prevention, resulting in substantial gains in the numbers of lives saved and infections averted; and (iii) predictability – stable, predictable resources stimulate market demand for the production of additional products, expanded research and development, and the creation of additional manufacturing capacity. Most importantly, predictability increases treatment effectiveness by lowering the likelihood of drug resistance and allowing the use of more expensive, newer treatments.

There is no near-to-market vaccine for HIV, but frontloaded resources could play a role in increasing the **funding for research**. The benefits would be realised in at least 10 years' time, but early estimates show that for each year we could bring forward a vaccine we could save up to 2 million lives and the equivalent of $40 billion. This supports the case for publicly financed research and development spending increasing by 50–75% over current levels, a rise of $300–450 million a year. This means that an extra $3–5 billion in frontloaded financing would be required over the next decade up to 2015. There are high start-up costs connected with the expansion of AIDS vaccine research and development – to establish trial sites, build up laboratory and other infrastructure, and create co-ordination and monitoring systems. The IFF would be well suited to providing this financing.

Aside from investment in the development and purchase of vaccines, the frontloading case is also strong for **malaria** – the international community under-stands the needs, and already has effective interventions. The World Health Organization (WHO) estimates that at least 2.3 billion people are at risk from malaria and that it kills between one and two million people in the world's poorest countries every year, including more children in sub-Saharan Africa than any other infectious disease. Malaria has been estimated to cost Africa more than $12 billion every year in lost GDP. And there are existing activities to combat malaria that can be scaled up immediately – bed nets and combination therapies.



Frontloaded finance could also be used to support **education**. There is strong evidence that education has significant private and social returns. Investing in education is one of the best ways to ensure economic prosperity and business competitiveness for developing countries, and it is essential to create an economy that has the flexibility to respond to market forces. Frontloading aid will help to provide the predictable finances that governments need for targeted programmes to get more girls into school, and to recruit and train the extra teachers needed at all levels of the system. Teacher salaries make up an estimated 60% of the financing gap for the primary education MDG. Evidence also shows that investing in education now will have spillover effects leading to improvements in health, nutrition and child mortality.



Water and sanitation is one of the most capital intensive of infrastructure investments. The March 2003 World Panel on Financing Water Infrastructure's report concluded that "in view of the capital intensive nature of water investments... means should be found for governments to create a special national or international facility to pre-finance disbursements budgeted for a later period... The panel has been encouraged to hear that suggestions of a similar nature are being presented by the Chancellor of the Exchequer." Financing from the IFF would be highly suited for funding investments in water and sanitation, as these have high economic and social rates of return, offsetting the initial outlay in the medium to long term. Policies and sector strategies for improving water and sanitation should be developed as part of countries poverty reduction strategies and given a high priority in scaling up donor support.

Building the **capacity to trade** presents a very strong case for frontloading. The up-front costs are large, but the economic and social returns are also high and clearly exceed the cost of IFF borrowing over the medium to long-term. The estimated economic rates of return from infrastructure projects in low-income countries are particularly high: 30-40% for telecommunications, over 40% for electricity, and over 80% for roads. Studies also show that infrastructure plays a particularly important role in delivering other MDGs. For example, a Moroccan study showed that paved roads doubled school attendance by girls. And electricity, which is vital to growth and trade, increased the number of Colombian children reading books in the evening from 43% to 72%.

The International Finance Facility for Immunisation

Alongside the Global Alliance for Vaccines and Immunization (GAVI) which includes UNICEF, WHO, the World Bank, The Vaccine Fund, and the Bill and Melinda Gates Foundation the UK and French governments have developed a pilot International Finance Facility for Immunisation (IFFIm). The IFFIm will use the frontloading principles of the IFF to provide urgently needed frontloaded funding for vaccine and immunisation services in the poorest countries all over the world. In addition to increasing the overall funding available for immunisation, this mechanism has the added merit of providing a predictable flow of resources to the immunisation challenge – where, historically, the lack of secure financing has impeded programme planning and product development efforts.

The IFFIm will demonstrate the technical feasibility of the larger IFF and the clear economic benefits of frontloading resources. Without the use of frontloaded investments, it will not be possible to scale up immunisation coverage to the level needed to reduce child mortality and help meet the MDGs. $4 billion spent over 15 years, without frontloading, would save an estimated 2.8 million lives before 2015. But by frontloading $4 billion over 10 years through the IFFIm mechanism, an estimated 5.3 million lives could be saved in the years to 2015, and a further 5 million adult lives from death caused by hepatitis B in adulthood. The economic benefits from years of life saved significantly outweigh the borrowing costs. We estimate an economic rate of return of well over 25%.

The UK has already announced that, over 20 years, it will provide one-third of the resources required for a $4 billion IFFIm.

Delivering aid to meet the MDGs

Substantial progress has been made in recent months towards increasing levels of aid. The agreement by the G8 and other donors to increase the levels of aid by around $50 billion a year by 2010, compared with 2004, shows donors' commitment to providing the finance necessary to meet the MDGs.

However, traditional increases in aid alone will not be enough to meet the targets set by donors. If the international community is to meet the MDGs by 2015, then these increases will be required now, not in five or ten years' time. In recognition of this, support for innovative financing mechanisms – such as the IFF and international levies, which are complementary to and could partly refinance the IFF – has continued to increase in recent months.

The IFF now has support from more than 80 countries, including France, Italy, Sweden, Brazil, China and South Africa, as well as from faith leaders, the business community and NGOs. The IFF also remains at the forefront of UN debates with strong endorsement from the Secretary-General, Kofi Annan. In addition, the World Bank and the IMF have stated that the IFF is technically feasible and the most advanced proposal to frontload aid. The Development Committee at the Spring Meetings of the World Bank and IMF in April 2005 also stated: "The analysis of technical feasibility of the IFF has created the conditions for the necessary political decisions on participation. We encourage interested donors to proceed with these proposals."

The UK continues to consult with governments, international institutions, faith communities, NGOs and business in both developed and developing countries to build on the existing support for the IFF and IFFIm as an immediate and concrete step towards achieving the MDGs.

Aid works: eliminating river blindness in West Africa

River blindness (or onchocerciasis) causes blindness, disfigurement and unbearable itching. But, over 30 years, donor funding for the Onchocerciasis Control Program resulted by 2002 in the elimination of the disease from 11 countries in West Africa, including Burkina Faso, Ghana, Mali and Sierra Leone.

The result: 600,000 cases of river blindness prevented, 5 million productive years of labour added to the economy, 16 million children with lives free of the disease and 25 million hectares of land available for safe settlement.

Development Initiatives

"The international community should in 2005 launch an International Finance Facility to support an immediate frontloading of official development assistance (ODA), underpinned by scaled-up commitments to achieving the 0.7 per cent ODA target no later than 2015."

Kofi Annan, speech to the UN, 21 March 2005.

"... an absolutely necessary and timely initiative and deserves an active response from all members of the international community."

Nelson Mandela, letter to G8 Heads, September 2003.

"The Church therefore welcomes the search for innovative solutions, such as the International Finance Facility."

Statement by Pope John Paul II to 100 church and NGO leaders at the Vatican seminar, Poverty and Globalisation, 9 July 2004.

"Ways of financing the doubling of aid to Africa should include the immediate launch of the International Finance Facility."

Commission for Africa Report, March 2005.

"We wholly endorse and support this proposal and look forward to its early implementation."

Heavily Indebted Poor Countries Finance Ministers' letter, 30 April 2004.

"… the IFF is elegant, timely, simple, necessary."

Bob Geldof, press conference, Addis Ababa, 7 October 2004.

Frequently asked questions

Why frontload aid? Is it wrong to borrow for development?

There is a moral imperative to act now to meet the MDGs, or risk losing another generation to poverty. Borrowing to invest is a well established domestic and development principle. All donor countries borrow to invest in their own future prosperity and deliver aid to other countries, while the IMF and World Bank are long-standing borrowers in the capital markets. The very significant returns to investing early easily outweigh the borrowing costs. The World Bank estimates that average returns to its aid programmes are around 25%, in comparison with annual borrowing costs of around 5%.

Will the borrowing be expensive?

Provided donor commitments are legally binding, and the risk of the high-level financing conditions being breached is sufficiently low, the IFF will be able to borrow at yields close to those of donor countries and other international organisations, such as the World Bank.

Is the IFF an alternative to 0.7%?

No. The UK Government is committed to reaching the target of 0.7% ODA/GNI, and, at current rates of growth, expects to do so by 2013. With the IFF, we could reach the equivalent of this target by 2008–09. The IFF should be seen as a complement to donors' long-term commitment to 0.7% ODA/GNI: it would meet the immediate need for resources as donors move towards the target.

Will frontloading mean a drop in aid flows post-2015?

No, we expect aid flows to increase beyond 2015. Donor countries have pledged to increase their aid budgets and the IFF will support these increases. After 2015, when the IFF will start to enter the repayment-only phase, aid flows are expected to continue to rise through further increases in aid budgets as well as the emergence of major donors, such as China, after 2015. If the IFF also increases aid effectiveness, as expected, then the IFF would be positively supporting the case for further increases in aid.

Can governments really commit to something over 20 years in the future, and what are the budgetary implications?

There are examples throughout the world where governments make commitments for lengthy periods – for example, in major procurement programmes such as transport or defence.

How will AAA credit rating be achieved?

Realistic assumptions about the financing framework include that:

i. the overall risk of countries breaching the high-level financing condition is sufficiently low to ensure that donor payments will allow the IFF to meet its obligations to its bondholders; and

ii. the individual credit ratings of donor countries will be good, and there will be a broad range of donors.

How many donor countries are required to launch the IFF?

The number of donor countries needed depends on the size of the commitment individual countries are willing to make. Clearly, a critical mass of donors is needed to achieve certain increases and to take advantage of scales of economy. The UK, France, Italy and Sweden support the IFF – in addition to over 80 developing and emerging market economy countries – and we continue to call for support from other donors.

Do developing countries have the capacity to absorb more aid?

The World Bank estimates that countries in Asia and sub-Saharan Africa could support at least a 60–100% increase in aid flows in the short term with substantially higher levels in the medium term. The World Bank has also estimated that, of the 65 countries unlikely to meet the poverty goal without further external assistance and/or policy changes, 43 could effectively absorb more aid today.

How will the IFF improve the effectiveness of aid?

Firstly, by locking in commitments from a wide range of donors, the IFF would provide recipient countries with predictable, stable and co-ordinated aid flows. Secondly, it could ensure that these aid flows are used effectively through donor agreement to high-level principles, such as investing in poverty reduction, untying aid and providing aid in predictable, multi-year programmes. Thirdly, the IFF would improve the transparency of development assistance allocation since the IFF's responsibilities to bondholders would mean that information on the spread of countries receiving IFF funds would be freely available.

What kind of organisation will the IFF be?

The IFF will be a temporary financing framework specifically designed to raise and allocate money needed to meet the MDGs by 2015. Its purpose is to raise money and it will not replace existing effective bilateral and multilateral mechanisms for disbursement. It will require only a small number of staff and administrative costs will be low.

What will the governance structures be?

The IFF will not establish a new aid bureaucracy and will disburse aid using existing mechanisms that have been shown to be effective. Funds would be allocated according to a set of high-level principles, helping to ensure the effectiveness of aid financed through the IFF. The detailed mechanics of how disbursement decisions are made will depend on the IFF's governance structure. Both this structure, and the high-level principles, will be for agreement through consultation with donors, recipient countries and the wider development community at the establishment of the IFF.

Which countries could benefit from the IFF?

The IFF will be explicitly designed to help meet the MDGs, so the majority of its funds will go to poor countries – for example, the poorest countries in receipt of concessional loans from the World Bank. There could be a limit on spending of finance raised by the IFF in any one country to ensure that a range of countries benefit and that the IFF receives the highest possible credit ratings for its bonds.