CSIS BRIEFS

The Global Development Finance Agenda and the G7 Hiroshima Summit

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THE ISSUE

- China's Belt and Road Initiative has eclipsed Western efforts on global development finance. Chinese funding is provided with few strings attached and promises to meet the significant infrastructure financing gap. Nonetheless, it comes with significant negative effects including unsustainable debt and a lack of environmental, social, and governance standards.
- The Group of Seven has launched its own financing tools in response, but these tools must be reformed to operate effectively.
- To increase the supply of "bankable" projects, development finance institutions should provide technical assistance, support reforms to improve the regulatory and business climate in developing countries, and provide support for domestic resource mobilization.
- However, development finance institutions and multilateral development banks will also need to address risk aversion among investors. Expanding concessional finance and leveraging innovative finance tools will be important steps in this process. Multilateral development banks will also need to adopt less conservative lending policies to provide a genuine alternative to Chinese investment.

INTRODUCTION

Over the past five years, the global economy has been rocked by the Covid-19 pandemic, significant supply chain disruptions, the war in Ukraine, and the looming specter of great power competition. This environment compounds existing development challenges for countries across the Global South, including a significant infrastructure financing gap. Beginning in the early 2000s, China massively increased its economic engagement with developing countries as part of an effort to secure raw materials, utilize excess dollar holdings, and find work for its large construction sector. Beijing formalized this approach in 2011 by launching the Belt and Road Initiative (BRI), which seeks to develop an integrated network of infrastructure projects tied to China. The ability of the BRI to fill global development gaps and establish strong economic partnerships may further position China as a **global leader** in trade, giving it the power to set economic standards that favor it and its partners as opposed to the Group of Seven (G7) and its allies. But the BRI has been a double-edged sword for many developing countries, which have seen their external debt skyrocket and faced new problems tied to China's weaker environmental, social,

and governance (ESG) standards for infrastructure projects. Consequently, China's growing international presence has only heightened the need for cooperation by G7 leaders on infrastructure development and other financing efforts to support their economic and security interests, especially in the developing world.

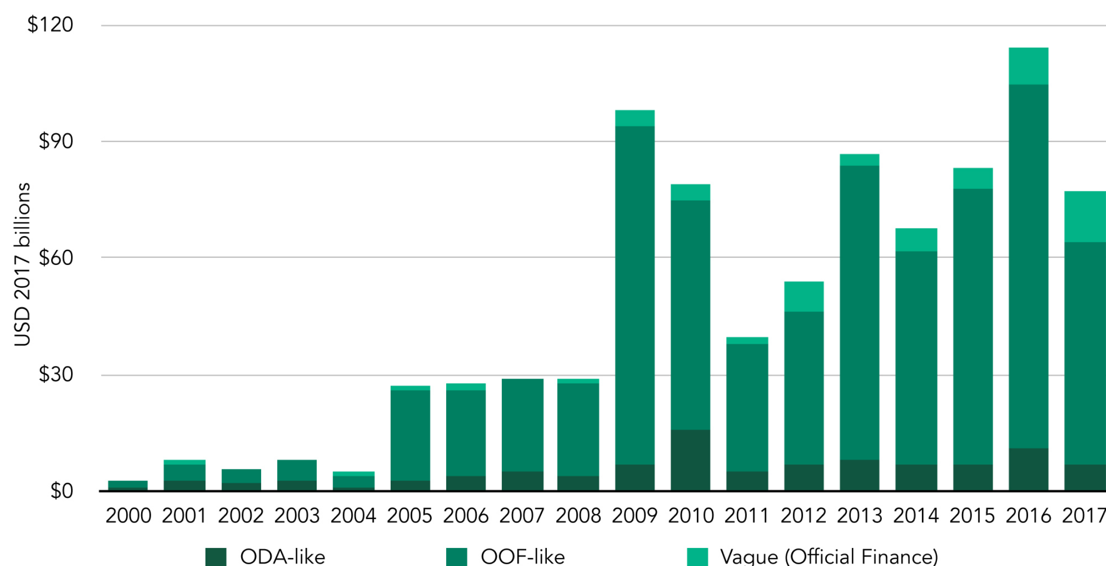
Japan, France, the United Kingdom, and the United States have sought to raise issues related to development finance on the G7's agenda so it can take a unified approach to finding an alternative to other state-led models. Their efforts include Japan's Partnership for Quality Infrastructure, the U.S.-led Blue Dot Network, and the G7's more recent Global Partnership for Infrastructure and Investment (PGII), announced in June 2022. All these initiatives are largely in response to China's significant increase in development financing through the BRI. Despite these efforts, much remains to be done. There is still a large unmet need for infrastructure investment, and rising debt levels complicate the ability of developing countries to continue to borrow while meeting existing debt obligations. Japan and the United States are also searching for ways to use development finance to support more resilient supply chains and develop partnerships with other allies in the Indo-Pacific region such as Australia, South Korea, and India.

This policy brief examines the current development finance landscape as it pertains to the upcoming G7 Hiroshima summit. It looks at China's significant role in development finance, including how trends have shifted in the last two to three years as China has adjusted its approach, as well as at initiatives launched by G7 countries, including the United States and Japan, and the challenges they are facing. Finally, it concludes with a set of recommendations for G7 stakeholders to strengthen these existing initiatives.

THE RISE OF STATE-LED DEVELOPMENT FINANCE

The BRI is a clear reminder of China's growing geopolitical and economic heft. China has established worldwide trade **partnerships** that benefit its economy and export markets, helping it become the second-largest economy in the world. To support this economic heft, it has provided significant volumes of official finance through the BRI to develop new hard infrastructure projects, further binding itself with countries in the Global South. China is responding to a legitimate need. Developing countries face a significant gap in the level of infrastructure finance available versus the finance they require. Countries need quality roads, railroads, port facilities, and other types of physical infrastructure to support economic growth and connect them to the global economy.

Figure 1: Official Development Finance Commitments from China, 2000–2017



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Through the **BRI**, China has made huge investments in Asia, the Middle East, Latin America, and Africa. Currently, most of its development financing comes from two central, state-owned **policy banks**: the China Development Bank and the Export-Import Bank of China. While there is a distinct lack of data due to Chinese lending secrecy, research by AidData estimates that lending from Beijing to developing countries totaled about **$843 billion** over the past 18 years. On an annual basis, China's new financing commitments peaked in 2016 at just under $120 billion and now hover around $85 billion per year. This dwarfs spending by the United States and other G7 countries, especially as much of U.S. foreign aid and that of other Western donors is directed toward non-physical infrastructure projects. The continued secrecy surrounding Chinese lending, amounts, terms, and projects has caused concern among Western countries, and this **lack of transparency** has raised serious questions about China's ethics for project implementation.

China has found willing partners because its approach does not require countries to implement politically challenging policy reforms, meaning they can swiftly approve a project and begin work. This stands in marked contrast to G7 donors and the multilateral development banks (MDBs), which frequently place stringent conditions on financing that delay the approval and launch of projects. China does, in fact, impose two conditions on its financing: (1) non-recognition of Taiwan; and (2) a willingness to allow Chinese construction companies to execute most if not all contracts related to the projects. There had also been a long-standing perception that China was undercutting G7 and MDB finance by providing more concessional interest rates and longer tenors on their loans; recent research by AidData shows that this is **not the case**. China's loans are far closer to market rates and tend to have a 10-year tenor, much shorter than most MDB loan terms. Speed and lack of preconditions are more attractive for many countries than better financing terms are.

That said, growing skepticism of China's approach has been compounded by the rising **indebtedness** of developing countries, with some estimates placing the BRI's hidden debt at a staggering **$385 billion**. Chinese financing for infrastructure development programs has proven to be largely **unsustainable** for much of the Global South. BRI lending in many low- and middle-income countries has been accused of being predatory due to its high commercial **interest rates (4.2 percent)** and relatively short **repayment periods (10 years)**. Cases of multiple countries facing **debt burden crises** certainly raise doubts about Chinese loans, Beijing's strategic motivations, and whether China is violating norms of global finance. One example is Kyrgyzstan, which owes approximately **42 percent of its current $5.1 billion debt** to China but has failed to begin generating profit on any of its BRI-funded projects due to economic downturns. Additionally, Sri Lanka's ongoing debt crisis has been directly linked to BRI lending, with **20 percent** of the country's total debt owed to China. Much like Kyrgyzstan, Sri Lanka has remained unable to generate commercial returns on Chinese infrastructure projects and has even been pressured to sign off on a **99-year lease** of its Hambantota Port to China. The Center for Global Development has identified **eight BRI recipient countries** as having a high risk of debt distress, with drastic implications for their debt-to-GDP ratios. Furthermore, AidData reports that roughly 42 countries owe public debt worth **more than 10 percent** of their GDP to China.

Another universal issue is the lack of environmental and social safeguards for infrastructure projects. MDBs recognize that projects may involve risks to communities and have developed a set of **rules and procedures** for assessing them. Many developing countries with weak governance find these rules to be **cumbersome** and have instead prioritized **Chinese finance options** that are flexible, impose fewer controls regarding the social and environmental impacts of their financing, and often do not include conditions related to recipient country policy. The benefit of relying on these easier options often comes at the cost of breaching international standards on **environmental and social safeguards**. For example, risk to wildlife or Indigenous communities has been identified in **over 60 percent** of development projects implemented by China worldwide. This raises questions regarding the degree to which China is willing to break these rules for the sake of development and whether the G7 is fully committed to these safeguards—or if it is comfortable with China spreading this rule-breaking norm.

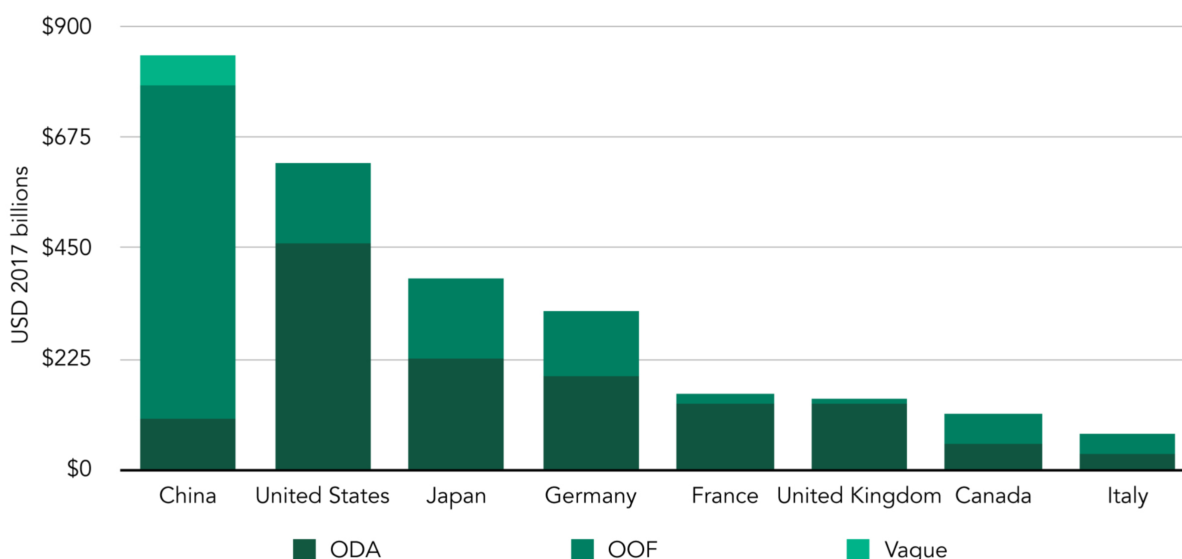
THE G7'S ROLE IN TRANSPARENT AND SUSTAINABLE DEVELOPMENT FINANCING

Japan was early among G7 countries to recognize the challenge posed by the state-led development finance model. Under Prime Minister Abe Shinzo, the Japanese government issued a revised Development Cooperation Charter calling for "quality growth" and **noted** that Japan would focus on "physical and non-physical infrastructure including that which is needed for strengthening connectivity and the reduction of disparities both within the region and within [the] individual countries" of Southeast Asia. It subsequently launched the **Partnership for Quality Infrastructure**, which seeks to offer a robust alternative for countries in the Global South. This initiative has relied on yen loans issued by the Japanese International Cooperation Agency (JICA), which initially committed to provide $116 billion in financing between 2016 and 2020. The Kishida Fumio government has continued this approach, committing to an additional **$75 billion** in infrastructure financing for the Indo-Pacific in March 2023.

Alongside Japan, other G7 countries—including the United States, France, and the United Kingdom—have raised infrastructure finance and development finance as strategic issues that should be tackled by the G7 as a collective. At least partially in response to perceptions of China's increasing role in development finance, the Trump administration reversed course and launched a wide-ranging reform of existing U.S development finance tools. This resulted in the **bipartisan** Better Utilization of Investments Leading to Development (BUILD) Act of 2018, which created a new agency, the U.S. International Development Finance Corporation (DFC), to provide greater resources and access to new tools to counter China's infrastructure approach. During this period, Congress also **reauthorized** the Export-Import Bank of the United States (EXIM) for a term of seven years, following a multiyear lapse in the institution's authorization. EXIM also sought to expand its role in sub-Saharan Africa and diversify its traditional client base through greater support for U.S.-based small and medium-sized enterprises.

In addition to these internal efforts, the Trump administration also engaged partners in two notable initiatives to create better alignment on issues related to development finance. First, the United States, Japan, and Australia created **the Blue Dot Network (BDN),** a quality-infrastructure certification program. Launched in 2019, the BDN sought to enable investors to better understand the risks associated with various infrastructure projects and incentivize countries to adhere to higher standards. The U.S. and Japanese governments later worked with the

Figure 2: China's ODA and OOF Portfolio Compared to G7 Countries, 2000–2017



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Organization for Economic Cooperation and Development to create a methodology to certify projects. Second, DFC leadership launched a "DFI Alliance"—a network of like-minded development finance institutions (DFIs), including those based in Europe, Japan, and Canada.

In 2021, at the G7 Cornwall summit, leaders announced their intent to develop a value-driven, high-impact, and transparent infrastructure **partnership** to meet the enormous infrastructure needs of low- and middle-income countries. Initially styled the Build Back Better World (B3W) Initiative, it sought to mobilize **$600 billion** by 2027, largely from the private sector, to invest in infrastructure projects. Under B3W, the G7 committed itself to prioritizing **investments** into four pillars: (1) digital technology, (2) climate change mitigation, (3) healthcare, and (4) gender equality. Subsequently, the G7 relaunched B3W as the Partnership for Global Infrastructure and Investment (PGII) at the June 2022 G7 Elmau summit in Germany. Through the PGII, the G7 promised to implement "**quality, sustainable infrastructure**"—in contrast to the BRI, which has been plagued by **corruption scandals and labor violations**. A vital element of the PGII is its ability to attract private sector investment and programming due to its low **ESG risks**.

These recent developments are not only focused on filling infrastructure gaps in developing countries but also aim to strengthen the **global economy and supply chains**. The G7 intends to promote transparency, coordinated partnerships, and labor and environmental protections by **mobilizing capital** from MDBs, DFIs, and sovereign wealth funds. These efforts are imperative in countering China's economic and political influence and reinforcing the continuation of a rules-based international order. Looking beyond the G7, the United States has also sought to engage with the Quadrilateral Security Dialogue ("the Quad")—made up of the United States, Japan, Australia, and India—on issues related to development finance in the Indo-Pacific region.

Despite these sustained efforts, challenges remain for the G7 to offer a credible alternative to China's state-led development finance model. First, the PGII and other G7 initiatives are based on providing incentives to mobilize private investment in infrastructure projects; the $600 billion target consists mostly of anticipated private capital mobilization. This structure of providing incentives—through grants, loans, guarantees, and other de-risking instruments—has proved challenging under other donor-led funding initiatives. To meet the United Nations' Sustainable Development Goals by 2030, for example, donors have sought to create a "**billions to trillions**" initiative to mobilize private capital. This has manifested as more of a "billions to billions" result as donors have struggled to align incentives, projects, and private investment. DFIs can play a critical role in this conversation but, to date, have generally not taken the risks needed to mobilize private capital in the volumes needed. To be successful, DFI stakeholders will need to push these institutions to adjust their risk/return profile—essentially, accepting lower returns in exchange for incentivizing less risk-averse investors to join projects.

Second, there is a lack of "bankable" projects that are structured in a way to attract private investment. To build a larger pipeline, there is need for additional technical assistance to support strategic planning, project preparation, feasibility studies, and other activities that will strengthen the capacity of governments in the Global South to evaluate and plan large infrastructure projects. Rather than focus solely on providing project financing, the United States and its G7 partners should look to increase the amount of technical assistance available to support these activities. The U.S. Trade and Development Agency (USTDA), for example, is well-positioned to meet these needs, though it cannot do so alone. Since 2019, the USTDA has received an increase in funding from Congress—which has rightly recognized its importance to infrastructure financing—that should enable it to do far more.

Third, the PGII and other development finance initiatives are conceived of as partnerships among the United States, European Union, and other G7 countries because no one country can fully meet the financing needs of the Global South alone. A partnership approach will create challenges in developing a common approach to providing financing for infrastructure and other activities. Different DFIs, for example, use different term sheets for potential deals, rely on different due diligence, and have different financing standards. The DFI Alliance is one effort to overcome some of these challenges by creating more commonality among G7 and other DFIs, but it remains more of a thought experiment than an actual effort.

FUTURE OF MDB REFORM

There is also an ongoing debate surrounding the future of the MDBs, particularly regarding the role they should or could play in providing "global public goods" and whether they can increase the amount of financing available. International leaders recognize that MDBs are **critical assets** for development programming due, in part, to their ability to provide shareholder capital and technical support to ensure a quality and sustainable development impact. The MDBs—especially the regional development banks—continue to provide significant support for infrastructure projects across the Global South. Yet many borrower countries see these institutions as inefficient and too slow in getting projects underway.

These challenges are also essential lessons for MDBs, which need to reevaluate the ways in which they distribute resources, funding, and lending to poorer countries. MDBs' **capital adequacy**, a measurement of their ability to honor their financial obligations if debtors are unable to repay their debts, is central to the power of international institutions to respond to development challenges. In an **independent review** of MDB capital adequacy in 2018, the Group of Twenty (G20) found that capital adequacy policies, particularly those serving middle-income countries, are often too conservative and that MDBs could safely lend more without threatening their extremely robust AAA bond ratings. This **overestimation** of financial risks has undermined the unique strengths of MDBs. A 2019 **working paper** by the Bank of Italy concluded that by applying an alternative rating methodology and allowing for a demotion to a AA+ credit rating, MDBs could more than triple their spare lending capacity from $415 billion to $1,370 billion without much change in funding costs. Thus, there is a need to reform the Advanced Capital Adequacy Framework so MDBs can use their maximum lending capacity to inject fresh capital into sustainable development projects.

RECOMMENDATIONS

The United States and its G7 partners have a momentous opportunity to present an alternative source of development finance to the Global South. This comes at a time when many developing countries believe that the G7 and other developed countries have failed to meet their commitments on several fronts, including responding to Covid-19, addressing climate change, and other areas of importance. Yet China's model of development finance cannot and should not be the only offer on the table; indeed, it appears to be under stress as China faces a debt-sustainability crisis across developing countries. Recent data suggests that since 2019, China has been a **net recipient** of financing from countries in the Global South as it has reduced the amount of new financial commitments. However, developing countries still face a significant shortfall in the financing available for infrastructure projects, climate adaptation and resilience, and the stimulation of further economic growth. This presents an opportunity for the G7 and other like-minded countries to provide a genuine alternative to China's state-directed approach to development finance.

Efforts such as the PGII, the European Union's Global Gateway Initiative, and Japan's Partnership for Quality Infrastructure seek to provide models that embrace transparency and accountability and offer a sustainable, private sector-led alternative. At their core, these initiatives are also implicitly structured as partnerships, recognizing that no one country can counter China's level of development finance on its own. This poses its own intrinsic challenges, and it will require significant engagement by the United States and others to develop processes that overcome potential pitfalls. There are three main barriers to private investment in infrastructure projects in developing countries and regions: (1) too small a pipeline for developing projects, (2) financial risks associated with projects, and (3) sovereign-level country risk. These three are not separate and do influence each other. The U.S. government and its G7 partners should take steps to identify these barriers at the country and project level and deploy collective resources to mitigate them through the PGII, Global Gateway Initiative, and other G7 efforts.

BUILDING OUT THE PROJECT PIPELINE

It is often stated that there is no shortage of capital but rather a shortage of bankable projects for investors to finance. Infrastructure projects require pre-planning analysis before the investment stage to mitigate potential challenges regarding ESG concerns. The U.S. government and its partners should prioritize the provision of technical assistance to governments and other entities that would enable successful project preparation. This

approach should build on successful examples such as Power Africa, through which the USTDA has provided significant support to help build a pipeline of bankable projects in sub-Saharan Africa's electricity sector. To support the PGII and other G7 initiatives, the U.S. government and its partners should create a pool of technical assistance provided to support the development of successful, sustainable infrastructure projects.

DE-RISKING FINANCIAL INVESTMENTS

The United States and its G7 partners possess significant instruments, including concessional finance, innovative financial tools, and guarantees, that it can use to help mitigate financial risks associated with infrastructure projects in developing countries. If the goal is to mobilize private capital to provide the bulk of needed infrastructure, then the G7 needs to be willing to take financial risk off the table in a sustainable and strategic manner. These instruments can be used to make potential projects more attractive to comparatively risk-averse investors and will be necessary even alongside work designed to improve the business and investment climate. Specific recommendations include the following:

- **Expand access to concessional finance**. The G7 should consider increasing the use of loans and guarantees provided directly to governments and other local partners. Japan, for example, provides a significant amount of concessional finance as part of its overall foreign aid portfolio. The use of yen loans by JICA, including the $75 billion announced by Prime Minister Kishida in March 2023, has supported its Partnership for Quality Infrastructure. The United States has largely abandoned the use of concessional finance, but the Millennium Challenge Corporation (MCC) and the U.S. Agency for International Development (USAID) should explore creating a concessional-loan facility that could provide sovereign or sub-sovereign funding specifically for infrastructure projects. Such an approach would enable a significant increase in the amount of financing available. Any approach should be done within a sustainable debt framework to ensure that countries manage their sovereign debt appropriately.
- **Leverage innovative financing**. Where appropriate, G7 DFIs should seek to take more risk by deploying innovative forms of financing, such as local currency loans and first-loss guarantees. At a time of rising interest rates in the United States and elsewhere, this would be welcomed in local contexts where dollar-denominated debt is increasingly expensive. Overall, G7 shareholders should push their DFIs to be more flexible and innovative in mobilizing private capital. Many DFIs remain risk averse, but they should also explore greater use of flexible tools such as first-loss guarantees that could make them more willing to take on risky tranches in a capital stack and thereby unlock greater private investment.

MITIGATING COUNTRY RISK

Perceptions of sovereign risk inhibit private investment by both international investors and locally based financial institutions. Addressing this will require support for key regulatory and institutional reforms that impact the business and investment climate. Power Africa has been successful not only in working on power purchase agreements but also in pushing for better regulatory conditions for electrical utilities at the country level—for example, by reducing electricity costs via subsidies. These efforts have made countries targeted by Power Africa more attractive for investors in the energy and electricity sectors. The G7 should incorporate this kind of regulatory work into its push for increased infrastructure finance.

- **Support reforms that improve the business and investment climate**. U.S. government agencies, led by USAID and the MCC, should provide additional support to improve the overall investment climate of "riskier" countries. Where applicable, the U.S. government should align its work with other G7 partners working on the ground. Ideally, this would include efforts targeting regulatory reforms, rule of law, and other governance and accountability measures that improve the overall climate for private investment. Expanding the number of countries that are eligible for the MCC selection process could be a good first step, particularly in sub-Saharan Africa. USAID could also play an important role in working with local partners, government ministries, and the private sector to promote better enabling environments that make it easier for foreign donors to invest.
- **Promote public financial management and domestic resource mobilization**. Globally, infrastructure is largely financed using tax and other

government revenue and by the issuance of debt by local governments. Countries in the Global South remain constrained on this front by shallow tax bases and the limited ability of local-level authorities to issue debt. The G7 should prioritize providing support for domestic resource mobilization (DRM) and public financial management (PFM) so countries can use more local resources to support infrastructure projects. This will be important to create sustainable sources of infrastructure finance, manage debt associated with these projects, and fund the ongoing maintenance of infrastructure.

As debt has risen in the Global South, financial outflows have reversed, with more financing flowing to China than from it. This presents the United States and the G7 with an opportunity to help developing countries close the significant gap in infrastructure finance. Efforts such as the PGII, the Global Gateway Initiative, and the Partnership for Quality Infrastructure hold much promise, but it will take sustained global leadership to convert these into genuine funding opportunities. At its core, the G7 is purposely seeking to counter China's state-led financing model by engaging the private sector as a key partner. This is important and should be welcome, but barriers remain that will need to be tackled. The G7 should not force countries to "pick a side" when it comes to infrastructure finance, but rather offer a positive, affirmative alternative. Right now, this remains more a promise than an actual initiative. The recommendations outlined above would help the G7 convert and scale up support for infrastructure finance. The time is now for the G7 to move aggressively to provide an alternative source of infrastructure financing. ■

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