AIDHEDGE

Efficient development assistance through innovative financial solutions

Executive summary

Financial uncertainties and inefficiency undermine development assistance and funding of sustainable development. Unmanaged financial risks, as well as ineffective transactions, can be found almost everywhere in the development sector. These two factors alone cause staggering losses of tens of billions of US dollars every year.

At the same time opportunities for vast improvements exist. The same challenges are well known from other sectors, and there is an array of best-practices as well as low-cost solutions available. In addition, the development sector also has untapped resources that could complement existing services and provide innovative financial solutions. Improvements could not only improve the quality of existing funding, but also contribute to an increase in the net value of both development assistance and funding for sustainable development.

This short note sketches both challenges and possibilities, and highlights some of the areas where further work could contribute to the catalytic change needed. This is a rare situation - a costly challenge where there are many simple solutions available.

Introduction

In 2017, official development assistance (ODA) totalled about USD **146.6 billion**. Together with a few other financial flows (such as remittances, FDI and philanthropic funding) ODA is a crucial instrument for global development and for the Sustainable Development Goals (SDG:s). **With an estimated funding gap of 2.5 trillion US dollars** to reach the SDGs, it is urgent to mobilize new funding, but also critical to ensure that every dollar spent reaches its intended target.

Partner governments in developing countries and implementing organisations are however struggling with funding that is not only insufficient, but also inefficient and **unpredictable**. Important parts of this pivotal funding never reach the intended target, because of expensive financial transactions or unmanaged financial risks. And this important question, of financial efficiency and getting every committed resource all the way to the intended target, is often overlooked when the focus is on mobilizing new and needed funding.

One of the most important challenges is predictable funding, i.e. that partners can be confident about the amounts and timing of financial disbursements. This has long been recognised by partner countries and donors alike, and predictability is a central concept in **the international agreements on aid effectiveness in Paris, Accra and Busan**. Increasing predictability has however been a slow process, and many partner organisations are still hampered in their work by simply not knowing exactly how much funding they will have - even after funds have been committed by donors and the contracts have been signed.

Development actors are, in addition to the financial uncertainties in donor funding, often faced with high financial risks and costs in the implementation of activities. Working in developing countries exposes development actors to financial risks, such as volatile inflation and currency rates. Many organisations are also exposed to fluctuating prices in commodities that are either purchased or sold as a part of activities.

These financial uncertainties are most often pushed down through the development system, **from donors to implementing actors**. The cost of risks and uncertainties are therefore mainly carried by the end-recipients or intended beneficiaries of funding. This also means that these challenges move from large actors with good capacity to manage them effectively, such as governments in developed countries or large multilateral organizations, to governments in developing countries, international charities, or local organisations. With lower capacity to handle these financial challenges comes higher costs.

Just volatility in funding from donors is estimated to cost **close to 20 percent** of the total value of ODA. That's tens of billions of US dollars per year that does not reach the intended target and impact.

Despite the significance of development assistance, as well as funding of sustainable development more broadly, there has been limited efforts to tackle these challenges. Both research and practical solutions are severely lacking. However, while available studies and reports do underline the challenges, several also highlight the fact that there are opportunities available that could contribute to significant improvements.

These challenges can roughly be collected into two categories, describing different but closely connected problems (and solutions).

Financial risk: Fluctuating exchange rates, commodity prices and inflation

A large majority of international activities in sustainable development, development assistance or aid are exposed to one or more financial uncertainty. When organisations are funded (or fund) activities implemented in different currencies, they are faced with questions such as:

- How much will we receive in funding during our project in our currency, when our donors have pledged support in their currencies?
- How much will the activities we have budgeted in other currencies actually cost (in our working currency)?

The value of resources is not only affected by fluctuating exchange rates however, but also by different inflation rates. In combination to the challenge of understanding how much funding will be received, many partner governments and implementing organisations will also have to factor in what those funds will be worth:

- How will changes in inflation(s) impact the available budget in my activity?

Partner governments and implementing organisations, as well as many intended beneficiaries, are in addition often faced with the challenge of fluctuating commodity prices. Many development or aid projects source important commodities on the international market. It can be equipment or construction materials just as well as pharmaceuticals for the treatments of HIV/AIDS. Others are faced with a similar uncertainty, building the intended impact on projected revenues from sales of commodities such as rice, coffee or cacao:

- Will I be able to source what I need to implement the activity, if prices change?
- Will the activity provide sustainable income when market prices fluctuate?

The above questions are a reality for most if not all development practitioners. They are simply facts when working in different currencies, purchasing commodities or having local costs. But even so, these challenges have not been met with practical solutions, to mitigate the financial risks and the cost of financial uncertainty. And, as mentioned above, uncertainties are most often pushed from the large donors out towards smaller actors with less capacity to cope with or mitigate risks.

These questions are truly commonplace in thousands of development activities, every year and all over the world. The number of research or practical studies of the effects are however very few. There is a selection of studies that describe different aspects of these questions from a macro perspective, on an aggregated level or as a part of the larger issue of predictability in aid.

In 2010 The World Bank concluded that since aid budgets are set in donors' own currency the appreciation of the US dollar (USD) against most donor currencies deflated aid measured in USD somewhere between USD 3 billion and 5 billion in 2009. **Dfid has reported** that exchange rate volatility has impacted directly on its purchasing power in a number of developing countries, as well as impacting on UK contributions to multilaterals. In **a recent annual report Sida reported** that several activities had been impacted negatively due to changes in exchange rates during 2015.

In the last number of years, a handful of studies have been published that more specifically focus on the question of financial risk or uncertainty and development assistance or sustainable development. The most comprehensive is **a report from the Swedish Expert Group on Aid Studies (EBA)**. The study covers the effect of exchange rate fluctuation on all bilateral Swedish development assistance during the period 2006-2016. It not only provides data on the significant effect on predictability, but also illustrates some of the effects on both efficiency and effectiveness in the implementation in funded activities. The uncertainty in Swedish funding is about (+/-) 10 % for the first disbursement of funding, and it grows for subsequent disbursements. A partner organisation will have to work with an uncertainty of about (+/-) 25 % for the third-year funding. The practical effects of this uncertainty range from over-contracting to lower implementation rates. While the EBA study focused on Swedish development assistance, it included a survey of practices from other donors. The conclusion was, unfortunately, that it was hard to find any best-practice solutions implemented by other donors as well.

It should be emphasized that this is not a question about possible losses from increased rates or or commodity prices. The main issue is the lack of predictability. Even in cases where fluctuating rates provide gains (if organizations are allowed to keep them) inefficiencies arise, as deviations from budget have to be managed with limited administrative resources.

For many partners or recipients, the challenge is substantially more complex, as funding often comes from multiple donors, working in multiple currencies. For some, this provides an insurance mechanism in practice (as some currencies depreciates while other appreciates), for others, the task is simply overwhelming, as the financial risk is fully transferred from donors to actors with less capacity to manage them.

The practical challenge of working with uncertain donor funding, and the lack of any risk management solutions, is described in a recently published article in **Oxford Health Policy and Planning**, Effect of currency exchange rate fluctuations on Aid Effectiveness in the Health Sector in Zambia. The article describes how the Ministry of Health (MoH) in Zambia is exposed to uncertain funding, working with more than 20 donors and eight major currencies. The challenge becomes even more daunting as the MoH also had to deal with fluctuations on the costs side of the budget. One part of the budget was in Zambian Kwatcha, covering local health care costs. The other was in USD, exposed not only to exchange rate fluctuations but to the international market prices (mainly pharmaceuticals).

As mentioned above, volatility is not just a question of exchange rates and the value of funds. The exposure to different kinds of commodities is also a significant challenge, for both development organisations and the intended beneficiaries. The sometimes extreme effects of fluctuating food prices has **long been an important question**, as **fluctuations** can have a direct impact on the food security for individuals, regions and entire populations. Assisting farmers is a **huge challenge**, and a on-going question **not only in developing countries**.

The uncertainty created by fluctuating prices is not only a direct challenge to farmers, but a risk that undermine effective budgeting for all organisations dependent on volatile commodities. How do you ensure effective implementation of a activity when the amount of resources in unclear? This is a common challenge, be it food, energy, building material or treatments. **A recent Dfid funded study**, for example, highlights the challenge of fluctuating prices on HIV/AIDS treatments in all of southern Africa.

These challenges are on the one hand both complex and costly, both in terms of efficiency and effectiveness. A the same time it should be noted that these are challenges that **are in no way unique to the development sector**. Fluctuating exchange rates, commodity prices or local inflation are all challenges also faced by the private sector when doing business in an international setting. This has resulted in a wide number of solutions and best practices. There is a significant body of research on how these types of financial risks can be managed in business dealings.

In the recent EBA report, a number of such available solutions were discussed for use in development assistance. It is argued that many solutions are not only readily available, but would also cost-effective and quite simple to include in current working practices. Furthermore, the authors point out that since a large part of development assistance comes from governments in developed countries, their available frameworks could possibly be used to provide additional benefit.

As an example, one solution is to use existing government financial structures to provide recipient governments and implementing partners with predictable funding in the relevant working currencies. The EBA report showed that such solutions were already in place for all major currencies, and could be used at not costs also in development assistance. As this would entail currency purchases by the government to highly competitive rates it would also be expected that the net funding (in received currencies) would increase as a result. A further increase of net funding could also be expected to arise from the financial instruments used in the transactions.

Financial inefficiency: transaction costs and interest rates

Development assistance, and the growing funding of sustainable development, amounts to hundreds of US dollars every year. As this funding flows between donors, investors, implements and recipients financial efficiency has an important impact on the overall value of funding. How transactions are made and how organisations take advantage of interest rates directly affects the total value of both ODA and other financial flows. Unfortunately, the available data indicate that substantial resources are lost in these processes.

- Expensive international transactions often reduce budgets with 2-4 %. Many organisations pay too much even when they purchase the major currencies.
- Not getting the best interest rate can in many cases deprive development actors as much as 5 % of their possible resources.

Taken together, seemingly small choices of how funds are kept and transacted have a huge impact on the total available development assistance and funding for sustainable development.

The available data is, as with the management of financial risk described above, limited. While there are information services being developed to compare transaction costs for micro-transactions (remittances) the same transparency and benchmarking is not yet available for larger transactions. But available studies indicate significant challenges, and not only for smaller organisations.

Two rare reports on the importance of transactions were published in the UK in 2009 and 2011, focusing on currency management in UK based charities. Beginning with **the first report, aptly named "Missing Millions",** the importance of efficient currency purchases are illustrated. Both publications highlight not only the losses, but the potential for improvements. The **second report** provides ample examples of best-practices, both from charities and from financial sector experts. While these types of studies are rare, a masters thesis from 2015 illustrates the **same challenges in Swedish NGOs**.

It should be emphasized that the problem with high transactions costs or expensive currency is not just a challenge for small organisations. Both in the UK and Sweden the studies included large international players, with budgets of tens and even hundreds of million US dollar. It's a challenge were even some of the largest development organisations struggle. A **performance audit performed by the Swedish National Audit Office** (SNAO) in 2014 concluded that the Swedish Government purchased currency for its development partners at extremely expensive rates. After the audit a new framework contract was negotiated, that will result in a decrease in the cost of currency currency purchases with more than 95 %.

Areas of further development, bringing innovative financial solutions to ODA and SDG funding

This is a area where, despite the significant amounts involved, very little has been done to promote innovative and efficient financial solutions. We are currently lacking everything from research to practical solutions. A the same time it is clear that there exist an untapped world of both expertise and practical solutions, readily available. This is simply put, an area where innovation is waiting to happen. A the same time, it is clear that there is significant work that needs to be done. The development sector has been exposed to many of the available best-practices for year without adopting them, so there are a number of clear thresholds and challenges.

Examine existing services and highlight available solutions. Many if not all of the challenges described above also face others. Many available services are just not used, even though they could provide drastic improvements. This is often because donors and development organisations aren't familiar with these services. But it’s This is a area where, despite the significant amounts involved, very little has been done to promote innovative and efficient financial solutions. We are currently lacking everything from research to practical solutions. A the same time it is clear that there exist an untapped world of both expertise and practical solutions, readily available. This is simply put, an area where innovation is waiting to happen. A the same time, it is clear that there is significant work that needs to be done. The development sector has been exposed to many of the available best-practices for year without adopting them, so there are a number of clear thresholds and challenges.

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But it is not only existing market solutions that should be examined. Many large donors have existing frameworks that could provide significant benefits directly, such as government solutions for currency hedging.

Explore services that could be created using existing solutions/structures. An increased (efficient) use of existing market solutions could improve funding. But it should be emphasized that not all problems can be solved with what already exist. Due to the high financial risk there are some challenges where the market just can't provide solutions. For such situations, development actors have a special toolkit, that could be leveraged. There are a widwe array of different financial tools available at government and multilateral donors, that could be used to meet these specific challenges. Government guarantees could for example provide the financial security needed to develop risk management solutions for currencies and commodities alike.

Establish sector specific working practices. While the financial solutions might look the same, there are often differences in the underlying financial logic of development assistance. Developing new methods, taking advantage of new financial solutions, might also be affected by some donor requirements. Therefore, it would be valuable to look at different use cases and provide methodological best-practices. For instance, questions around how to establish a cash-management prognosis sufficient to build hedges on, or the practical question of how to combine donor requirements, financial solutions and the management of divergence from budget for other reasons (low implementation rate, unforeseen local changes, etc), are two interesting areas to investigate.

Provide a test beds and policy labs. A major threshold for innovation in this area is the lack of sector cases/best practices: Actors are unaware/sceptical towards available solutions. This could be bridged by case studies including so called policy labs or similar. This involves testing new working practices in cooperation between donors and partners organisations, creating labs where new possible policies are tested practically.

Capacity building, capacity building capacity building! Exploring available services, developing new ones or doing research is important. But a major challenge is getting effective working practices, new and existing, out into the development sector. Here again is an opportunity to work together with financial actors, as the adoption of new financial services should be of interest to many of them.

Further knowledge about the cost. Change needs to come from an understanding of the problem and getting there we need to ensure that there is both more analysis and better data. A common theme in all available studies is that there is a low awareness of the costs involved in inefficient financial management. The resources that are lost due to expensive rate or unmanaged risks simply dont end up in the current financial reports. This is partly because of reporting practices, and partly due to a lack of awareness. Available open reporting (IATI/OECD) don’t cover the relevant financial data needed for analysis. There are few studies, and most stop at the macro-economical level. To further knowledge we will need more well-designed case studies, clearly illustrating the costs involved. And to really promote large scale change, financial data in reporting needs to be improved to enable aggregated research and studies.