

# **The Use Of Credit to Promote Sustainable Development**

## **Environmental Framework Papers**

**The Center for Environment**  
USAID Bureau of Global Programs,  
Field Support, and Research, Washington, DC 20523-1812  
January 1997

# **Environmental Framework Papers**

## **The Use Of Credit To Promote Sustainable Development**

Urban environmental problems threaten Americans, both at home and abroad. Pollution produced in cities respects no boundaries and counteracts efforts to clean up the atmosphere and oceans we share. The degraded urban environment in developing countries also helps propagate the wave of illegal immigrants looking for a better life in America. Finally, as the U.S. depends more and more on a global economy, Americans are vulnerable to the effects of environmental degradation in areas to which they must travel and where the products they consume are grown or produced.

Access to credit is essential to financing the range of needed environment-sustaining projects. These include, but are not limited to, the provision of low-income shelter and environmental services, such as potable water, sewers, water treatment, and solid waste management.

The use of credit for environmental improvement is one focus of U.S. foreign policy and, therefore, of the U.S. Agency for International Development. As the foreign assistance arm of the U.S. government, the Agency plays a key role in helping the U.S. realize its credit-related sustainable development assistance goals. The following issues are briefly discussed in this document:

- \* The rationale for extending credit to promote sustainable development
- \* USAID's approach to the credit problem
- \* Results of the Agency's efforts
- \* Lessons learned

### **The Rational For Extending Credit To Promote Sustainable Development**

Cities of the developing world are struggling to respond to the enormous investment needs created by the urbanization process. Lack of credit is a major cause of the cities' inability to address these needs. Unmanaged urban growth ensues, resulting in an ever-increasing population exposed to locally and globally transmitted health risks, severe constraints on a country's ability to participate in the global economy, and increasing numbers of urban poor people. The impacts can be widespread -- and felt in neighboring countries -- as diseases cross international borders causing suffering and loss of life and as decreased productivity causes economic losses.

There is a critical need for investment funds to finance sustainable development. Lack of central funding means that local governments must use their capabilities to explore new alternatives, such as local resource availability and partnering options with non-profit and for-profit enterprises. The private credit markets serve as one of the most important leveraging tools for developing country governments. Access to credit can catalyze a number of environmentally sound ventures for urban settlements, ranging from large-scale, capital-intensive projects for potable water supply, solid waste management, and wastewater collection and treatment to small-scale, informal efforts in low-income households to provide clean drinking water, sanitation, and basic shelter.

The following converging worldwide trends offer a unique opportunity for international development agencies in general, and USAID in particular, to help developing countries address their credit needs:

- \* a diminishing supply of both foreign donor and central government funding for investments in urban settlements;
- \* increased responsibilities and authorities for local governments;
- \* increased citizen participation; and
- \* a better understanding of the role that the private non-profit and for-profit sectors can play in helping provide some of these investment needs.

## **USAID's Approach To The Credit Problem**

Over the past 30 years, USAID has perfected a sustainable development approach that uses credit provided through the Agency's HG program. This approach is unique in the international development community and was recently cited at the Habitat II conference as a well-established, bold, and effective development tool for helping cities. Since the 1960s, USAID has applied about \$2.6 billion in credit to assist more than 28 million poor men, women, and children, in 48 developing countries around the world.

The approach combines the use of USAID-funded credit resources with technical support funded by USAID missions in the field. Long-term local currency credit resources are used to provide "seed funding" for demonstration capital assistance interventions, such as potable water supply, wastewater collection and treatment, solid waste collection and disposal, and market-rate loans for basic shelter improvements. The untied U.S. dollar credit resources are borrowed by sovereign or non-sovereign borrowers, only after significant progress has been achieved on key policy changes that inhibit sustainable development. USAID grant funds are used to provide technical support for the counterparts' efforts to achieve the policy changes.

This approach provides an efficient, effective, low-risk way to use scarce foreign assistance dollars to meet USAID's sustainable development objectives. Since the Credit Reform Act of 1992, Congress annually appropriates credit reserves to cover potential liabilities of the program. In FY95, \$19.3 million in credit reserves leveraged \$148 million in HG commitments to seven countries. In FY96, Congress appropriated \$4 million, which will generate \$56 million in HG commitments to four countries.

### **Results Of The Agency's Efforts**

The USAID guaranty program has significant, long-term work in 10 countries -- Thailand, Indonesia, India, Sri Lanka, South Africa, Zimbabwe, the Czech Republic, Hungary, Tunisia, and Morocco -- as well as in Central America. The total capital assistance to be provided is \$643 million, of which \$190 million has already been borrowed. New long-term sustainable development needs have been preliminarily identified in Poland, Mexico, Brazil, the Philippines, Central America, South Africa, and Indonesia.

Each program intervention -- typically over four or five years -- is designed and implemented through the Agency's regional Urban Program offices, which collaborate with USAID missions throughout the world. The programs are long-term cooperative efforts, with host-country institutions acting as borrowers (either a government ministry or a non-sovereign financial intermediary -- parastatal or private sector).

A policy change agenda is mutually agreed upon. USAID guaranty funds are borrowed and portions released when significant progress has been achieved on policy changes. Examples of such progress include:

- \* increased access by informal sector borrowers to formal sector credit;
- \* promotion of market-based deposit and shelter loan interest rates;
- \* local government partnering -- both non-profit and for-profit;
- \* local government decentralization;
- \* improved citizen participation;
- \* improved urban management capabilities; and
- \* more sustainable pricing for environmental services.

A mission-funded technical support program is developed to help the counterparts' achieve substantial progress. For FY95, the \$148 million in USAID guaranty capital assistance was supported by \$52 million for technical support; for FY96, \$55 million in capital is being supported by \$30 million for technical assistance.

Eligible expenditures, affordable to below median-income households, are grouped into two categories: shelter improvement loans and urban environmental services, including infrastructure. Of the \$643 million to be provided to the 10 countries and Central America, about one-third is for shelter improvements and two-thirds is for environmental services. In almost all

cases, counterparts are required to match the USAID guaranty capital assistance -- in some cases by two or three times. The total amount of assistance to these 10 countries and Central America will be well over a billion U.S. dollars. Almost \$400 million has already provided roofs and protection from such diseases as cholera, hepatitis, malaria, and dengue fever for about 662,000 poor men, women, and children.

### **India: Housing Finance Program**

USAID's support for India's housing finance system began in 1981. Its goal was to demonstrate that a commercial business can mobilize domestic resources, make loans at market rates of interest to lower-income households, and provide a reasonable return to its investors. Initially, the program focused on India's first private sector housing finance company -- the Housing Development Finance Company (HDFC). Based on the initial success of HDFC, in 1989 USAID's support evolved into assistance to create a system of HDFC imitators. Specific support for HDFC ceased.

Since 1981, USAID has provided about \$6 million in technical support and \$150 million in HG funds -- \$125 million to HDFC and \$25 million to India's National Housing Bank, which was on-loaned to five newly formed housing finance companies.

The HG capital assistance combined with technical support has played a seminal role in making HDFC a major actor in India's financial markets. As of March 1996, HDFC's total assets are valued at \$1.93 billion. More than three-quarters of its stock is now owned by individual investors and corporations. In 1996, stockholders earned a net profit of \$57.4 million. HDFC has made more than 600,000 loans, of which about 150,000 were for basic shelter improvements by lower-income households.

The program has also had broad systemic impact. It effectively helped expand the market-oriented housing finance system in India. There has been a substantial increase in the number of housing finance companies (HFCs) from 1 to more than 30, with a branch network of 350 offices throughout India. Much of this expansion was in smaller cities, allowing HFCs to reach a significantly larger lower-income population. As of March 1996, more than 1 million low- and middle-income Indian household have benefited from improved shelter conditions. More than 5 million construction workers have benefitted from meaningful employment.

Other important spin-off benefits have occurred because of this program. The program provided an opportunity for HDFC to participate in U.S. capital markets and develop commercial relationships with the U.S. financial services community. When India shifted to a market economy, HDFC was positioned to take advantage of these relationships.

HDFC was limited by regulation to the middle- and lower-income housing loan market. As demand for loans increased, HDFC formed a partnership with a major U.S. bank that used HDFC's branch system to originate and co-finance higher-income loans. Through this partnership, the U.S. bank gained entry into India's expanding financial markets.

As HDFC evolved into a robust and sizeable financial institutions, it looked for opportunities to diversify into other consumer finance products. A large U.S. finance company was exploring opportunities to enter India's financial markets. The two joined forces because the U.S. company's normal two to three year start-up time was compressed to six months, due to HDFC's extensive branch network and effective personnel system. The joint venture is now one of the leading auto finance companies in India.

Finally, through the USAID program, HDFC was the recipient of significant technical support from U.S. experts. To satisfy its own staff expansion needs, it developed a state-of-the-art training center, staff, curriculum, and publications. Through its contacts with other international donors and lenders, such as UN Habitat and the Asian Development Bank, HDFC's training center has provided technical support for housing finance system development in other developing countries, such as Sri Lanka, Nepal, Vietnam, and Russia.

### **Czech Republic: Infrastructure Finance Program**

The Infrastructure Finance Program was initiated in 1994 and provides \$60 million in USAID capital assistance -- in the form of an HG loan -- supported by \$10 million for technical support over four years. The purpose is to facilitate the creation of a fully functioning, market-based municipal infrastructure finance system. HG funds are used to capitalize a financial intermediary, the newly created joint stock company called MUFIS (Municipal Infrastructure Finance Fund).

The program's policy agency included:

- \* establishing a temporary market-oriented, financially sound financial intermediary;
- \* demonstrating acceptable credit and business risks in lending to municipalities;
- \* increasing domestic resources for municipal investment;
- \* improving the capacity of local government to plan, finance, operate, and maintain infrastructure investments; and
- \* reducing the flow to government loans and grants for municipal investments.

In 1995, the first \$20 million was borrowed and reloaned to nine Czech commercial banks. The results have been quite remarkable.

When the program began, the most common commercial loan maturity was four years, and commercial banks did not make loans to municipalities. Under the program, all of the loans are to municipalities for repayment over 10 to 15 years. This is important, as the longer maturity makes the infrastructure improvements more affordable. Before the program's inception, municipalities depended on government-backed loans with interest rates at 15 percent to 16 percent. Due to market competition generated by the program, interest rates are now at 11.5 to 12 percent.

The \$20 million has produced 35 completed infrastructure projects, which have benefited 124,000 men, women, and children. All are unsubsidized, commercial loans at market rates, which produce direct and tangible environment and energy benefits for people. The investments include water supply, wastewater treatment, landfills, and energy.

The town of Dolni Kounice, for example, had long suffered from serious winter pollution because all of the village's 750 homes were heated with soft coal, a known carcinogen. A commercial loan provided the capital necessary to connect all homes to natural gas for heating. This enabled the people to enjoy their first winter free from the hazy, choking, overcast caused by coal smoke. The same loan extended gas power to a brick factory that had been idle since 1934. The reopened factory now employs about 40 people and is the first new employer in the village for decades.

### **Central America: Municipal Finance Program**

PROMUNI is the Municipal Infrastructure Finance component of a larger USAID decentralization project in Central America. The program provides \$20 million in HG capital assistance supported by \$20 million for technical assistance and training activities.

The program was designed by USAID to provide municipalities with financing for infrastructure, while at the same time facilitating the development of a new and sustainable credit system in Central America to finance environmentally sound urban infrastructure services to low-income families. It is administered by the Central American Bank for Economic Integration (CABEI), using HG funds provided by USAID and CABEI's own resources. CABEI has successfully lent funds to public and private financial intermediaries in participating countries that, in turn, on-lend to municipalities for financing urban environmental infrastructure projects.

The policy agenda of the program includes the promotion of municipal financial autonomy, increased citizen participation in project selection and development, and improved municipal financial practices. The USAID program attempts to shift responsibility for providing infrastructure from central government to the marketplace as well as to local governments, whose citizens are committed to paying for infrastructure and local services.

In 1995, \$7 million was borrowed by CABEI and on-lent to financial intermediaries. To date, 17 municipalities have packaged projects for presentation to financial institutions. Thus far, the two electrification projects under way in Guatemala benefited 953 families. These are unsubsidized, commercial loans to fund projects in which citizens have directly participated in project selection and development.

The discipline of market credit is brought to the entire project cycle, particularly to municipalities whose need to comply with loan provisions and repayment schedules compels municipal officials to manage their projects more closely. The project has also provided an incentive for municipalities to get their "houses in order" to become eligible for market-driven credit.

### **Lessons Learned**

The following lessons have been derived from USAID's experience with credit programs.

**\* USAID credit, through the HG program for capital assistance, has proven itself to be an effective and durable development tool.** It provides large-scale funding to undertake projects that demonstrate essentially needed policy changes. It provides hard-currency incentives for counterparts to be committed stakeholders in the policy change process.

**\* When used as seed funding, credit is an essential catalyst for sustainable development in that it can mobilize domestic capital resources to finance follow-on activities.**

**\* Grant-funded technical assistance is essential because it provides the expertise and training needed by counterparts to effectively advocate policy changes with key public and private policy makers.**

This approach is an efficient, effective, low-risk way to use scarce foreign assistance dollars to meet USAID's sustainable development objectives. Congress annually appropriates credit reserves to cover potential liabilities of the program. Every \$1 dollar of appropriated credit reserve generates from \$7 to \$10 dollars of credit for capital assistance.

### **The Center For Environment**

The Center for Environment, located in USAID's Bureau for Global Programs, Field Support, and Research, coordinates the Agency's environmental programs. The Center provides technical and programmatic leadership and support to the Agency, its field missions, and its domestic and international development partners on global and sustainable development problems.

The Center's portfolio focuses on program areas of Sustainable Living Resources, Sustainable Energy Systems, and Sustainable Cities, as well as on USAID's commitment to combating global climate change and loss of biodiversity. Activities under each program area emphasize the centrality of the U.S. national interest, the importance of public-private partnerships, and the equitable allocation of costs and benefits.

The Office of Environment and Urban Programs oversees the Agency's credit programs for sustainable development, in cooperation with the policy and regional bureaus and USAID missions.

*For more information on these USAID programs, contact:*

David L. Painter, Director  
Office of Environment and Urban Programs  
Center for Environment  
TEL: (202)-712-5113  
FAX: (202)-216-3174  
[dpainter@usaid.gov](mailto:dpainter@usaid.gov)