

Perspectives on Financing for Development

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| • AAAA | Addis Ababa Action Agenda |
| • ABP | Algemeen Burgerlijk Pensioenfonds |
| • ADB | Asian Development Bank |
| • AfDB | African Development Bank |
| • AMC | Asset Management Company |
| • AUM | Assets Under Management |
| • B2T | Billions to Trillions |
| • BEPS | Base Erosion Profit Shifting |
| • BSDC | Business and Sustainable Development Commission |
| • CDC | Commonwealth Development Corporation |
| • DAC | Development Assistance Committee |
| • DFIs | Development Finance Institutions |
| • DRM | Domestic Resource Mobilisation |
| • EBRD | European Bank for Reconstruction and Development |
| • EIB | European Investment Bank |
| • EPF | Equity Participation Facility |
| • ESG | Environmental Social and Governance |
| • FCS | Fragile Conflict States |
| • FDI | Foreign Direct Investment |
| • FfD | Financing for Development |
| • GDP | Gross Domestic Product |
| • GFSN | Global Financial Safety Net |
| • GIIN | Global Impact Investing Network |
| • GP | General Partner |
| • GPFG | Government Pension Fund Global (Norway) |
| • GPIF | Government Pension Investment Fund (Japan) |
| • HIPC | Highly Indebted Poor Country |
| • IFC | International Finance Corporation |
| • IFFS | Illicit financial flows |
| • IMF | International Monetary Fund |
| • LDCs | Least Developed Countries |
| • LICs | Low Income Countries |
| • LP | Limited Partner |
| • MDB | Multilateral Development Bank |
| • MDRI | Multilateral Debt Relief Initiative |
| • MIC | Middle Income Countries |
| • MIGA | Multilateral Investment Guarantee Agency |
| • MIRA | Macquarie Infrastructure and Real Assets |
| • NBIM | Norges Bank Investment Management |
| • NDBs | National Development Banks |
| • NGO | Non-Governmental Organisation |
| • ODA | Overseas Development Aid |
| • OECD | Organisation for Economic Co-Operation and Development |
| • OPIC | Overseas Private Investment Corporation |
| • PE | Private Equity |
| • PINAI | Philippine Investment Alliance for Infrastructure |
| • PPPs | Public-Private Partnerships |
| • SAFE | State Administration of Foreign Exchange (China) |
| • SDGs | Sustainable Development Goals |
| • SOFAZ | State Oil Fund of Azerbaijan |
| • UNCTAD | United Nations Conference on Trade and Development |
| • UNDP | United Nations Development Programme |
| • WB | World Bank |

About the author



Sony Kapoor is Managing Director of Re-Define, an international Think Tank and CEO of Court Jesters, a boutique corporate and investor consultancy, through which he advises governments, central banks, regulators, institutional investors and large corporates. He has been Strategy Adviser at the Systemic Risk Centre and a Senior Visiting Fellow at the Development, Government and European departments of the London School of Economics. An ex-investment banker, Mr Kapoor has also been an adviser to the European Union, OECD, UN, IMF and the German and the Norwegian governments. His many achievements in international development, management of the Eurocrisis, green finance and financial reform have been recognised by the World Economic Forum and Friends of Europe, where he is a Young Global Leader and a Young European Leader respectively. He is an alumnus of the Indian Institute of Technology and the London School of Economics, and a Fellow of the Royal Society of Arts.

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About Re-Define



Re-Define is an international Think Tank best known for its cutting-edge and influential work in the management of financial crises, including the euro crisis. It draws on a truly international pool of talent of financial professionals, economists, development practitioners, environmental experts, policymakers and corporate leaders to provide pragmatic policy advice on the most pressing public policy challenges. It is the trusted partner of several EU and emerging economy governments, as well as international policymaking institutions and long-term investors. Re-Define works in a cross-disciplinary manner across sovereign borders and traditional organisational silos to promote new approaches to tackling complex problems. It runs programmes on international development, sustainable economy, governance and finance, reforming the EU and technology and society. Re-Define has been widely recognised for its significant contribution to the improvement of public policy in the EU since its launch in 2008.

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Civita is dedicated to explore and strengthen the understanding and support of liberal ideas, institutions and policies to promote a society constituted on the principles of individual liberty and personal responsibility.

Civita aims to realize its mission through research and analyses, educational programs, seminars, public meetings, publications and active participation in public debates.

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EXECUTIVE SUMMARY

The analysis in this report brings out the following key perspectives.

First, that Overseas Development Aid (ODA) flows to the Least Developed Economies (LDCs) are still lacking and that there is an underfunding of Global Public Goods.

Second, that many of the poorest countries that benefited from the cancellation of their debts in the last decade have, through a combination of irresponsible borrowing and irresponsible lending, started to again build up unsustainable levels of debt that will need to be tackled soon.

Third, while Foreign Direct Investment (FDI) and private portfolio flows are flowing to many middle-income countries many of the LICs and LDCs still do not get enough FDI outside of the extractive sector. Moreover, the terms of this FDI can sometimes be onerous.

Fourth, while many economies have seen a significant improvement in their domestic tax take, far too many of the poorest economies still do not raise enough domestic revenue to maintain the basic functions of a state. They often do not have enough administration capacity, and revenues are undermined by huge illicit financial flows.

Fifth, there is a broad emergent consensus around championing private sector-led development that focuses on mobilisation of large amounts of commercial capital, the so-called Billions to Trillions agenda.

Sixth, for a number of reasons laid out in this report, there has never been a more propitious time to persuade \$80 trillion of institutional capital to invest much larger amounts into emerging and developing economies.

Seventh, a large portion of such investments can help plug the SDG funding gap, particularly in infrastructure but also beyond, while simultaneously allowing investors to generate reasonable profits and diversify their portfolios.

Eighth, Development Finance Institutions, the original impact investors, are perfectly placed to help catalyse these financial flows.

Ninth, for this to happen, Development Finance Institutions (DFIs) will have to refocus their business models.

Tenth, even with good policies and best efforts, including support from blending, this will not be enough to plug the Sustainable Development Goal (SDG) funding gaps fully.

RECOMMENDATIONS FOR NORWAY

The fact that aiding domestic resource mobilisation, tackling illicit financial flows, reforming DFIs, redeploying institutional capital and dealing with over-indebtedness emerge as some of the main priorities of the Financing for Development Agenda, particularly in 2018, puts Norway in a pole position to take the lead on setting the agenda for funding the SDGs. Let us tackle these issues one by one.

Domestic Resource Mobilization

Norway, through its pioneering Tax for Development¹ program of technical assistance to developing economies for building up their tax capacity has already been contributing to increasing domestic resource mobilization capacity in poor economies. This program should be expanded both in size and scope, in order to include assistance not just for capacity building, but also assistance for recovering lost tax revenues. Norway should also actively advocate for such capacity-building efforts to be expanded in line with the Addis Tax Initiative² Pledge to double technical cooperation on domestic resource mobilization by 2020 and expand support for international initiatives such as the International Tax Compact.³

Given the endemic problem of poor capacity in many developing economies to negotiate with large extractive sector firms, which often result in onerous terms that do not deliver fair mobilization of domestic resources, Norway's Oil for Development⁴ program should be expanded in size and scope to include technical assistance across the spectrum of natural resources. The objective would be to better design extractive regimes and contracts so that greater natural resource revenues are generated and retained in the country, and that they are managed better, including, where appropriate, through the launch of a sovereign wealth fund.

Tackling Illicit financial flows

A decade ago, Norway took the lead in putting the need to tackle illicit financial flows squarely on the international agenda through the launch of the Illicit Finance Task Force.⁵ This helped put many of the most promising policy developments such as country-by-country reporting, disclosure of beneficial ownership of companies, tackling tax havens and the need to reduce the magnitude of illicit financial flows on the international agenda.⁶

While much progress has been made since then, there is a lot of unfinished business. Norway should convene a follow up to the task force in 2019 to revisit progress on the agenda set up by the Illicit Finance Taskforce, and prioritize areas where big gaps between aspirations and actual policy developments remain.

Domestically, Norway has been ahead of the curve on the issue of beneficial ownership, with the Parliament's adoption of the need for a transparent and publically accessible register of beneficial ownership in 2015.⁷ However, this has not been put into legislation, and Norway should not only adopt this in 2018, but also promote this as the gold standard in beneficial ownership legislation that it should advocate for other governments to adopt.

Norway should ensure that the Tax and Transparency expectations document from the Oil Fund is implemented and acted on by the companies the Oil Fund holds stakes in.⁸ Research

has shown that almost 20% of the Oil Fund's investments are heavily exposed to tax havens, and that aggressive tax avoidance practices making them vulnerable to ethical, financial and reputational risks.⁹

The Oil Fund must tackle these risks proactively through a mix of engagement, divestment, stress tests and transparency. Last but not the least, listed Norwegian firms should be required to follow and exceed the minimum standards on tax and transparency set out in the Oil Fund's expectation document.

Last but not the least, Norway should not only advocate for a stronger role for the UN Tax Committee¹⁰, which has a greater legitimacy amongst developing countries in international tax affairs, but it should also ensure that developing economies are able to benefit from the work undertaken at the Organisation for Economic Co-Operation and Development (OECD) on tackling tax avoidance and tax evasion.¹¹

Reform of Norfund

As part of the discussion on mobilizing private sector resources for investing in SDGs, it is imperative that the development finance institutions such as Norfund are able to play an increasingly important role in helping facilitate this effort. For this, Norfund should be given more resources, allowed to expand manpower significantly and be asked to set mobilization targets. It should be encouraged to set up more partnerships of the kind it has launched with KLP and with Rabobank.

As recommended in 2013¹², Norfund should be allocated a pot of institutional capital by the Oil Fund to deploy alongside its own capital and capital from other institutional investors such as KLP.

Redeploying oil fund capital

As of today, the Oil Fund invests in about thirty-eight developing and emerging economies, only half of which - just twenty-one - are part of its benchmark. For the most part, these investments are very small, and in total the Fund has less than 14% of its total investments in developing and emerging economies. Not only does this mean that the Fund underperforms its peer group that have higher shares of investments in faster growing developing economies, but it also means that the Fund has taken on a highly concentrated and risky bet on OECD economies, where growth is slow and risks are rising. So much so, that the Fund now expects that it may lose as much as 40% of its face value in case of a downturn in markets.¹³

As has been repeatedly suggested¹⁴, the Oil Fund should seek to invest at least 40% of its portfolio value in developing economies, which already constitute more than 50% of the global economy (and rising)¹⁵, and, as in 2017, contribute more than 75% of total global growth.¹⁶

To begin with, this should happen through partnerships with Norfund, the IFC and other development finance institutions, but should eventually expand to include direct investments, including in infrastructure and private equity in developing economies.

Dealing with international debt

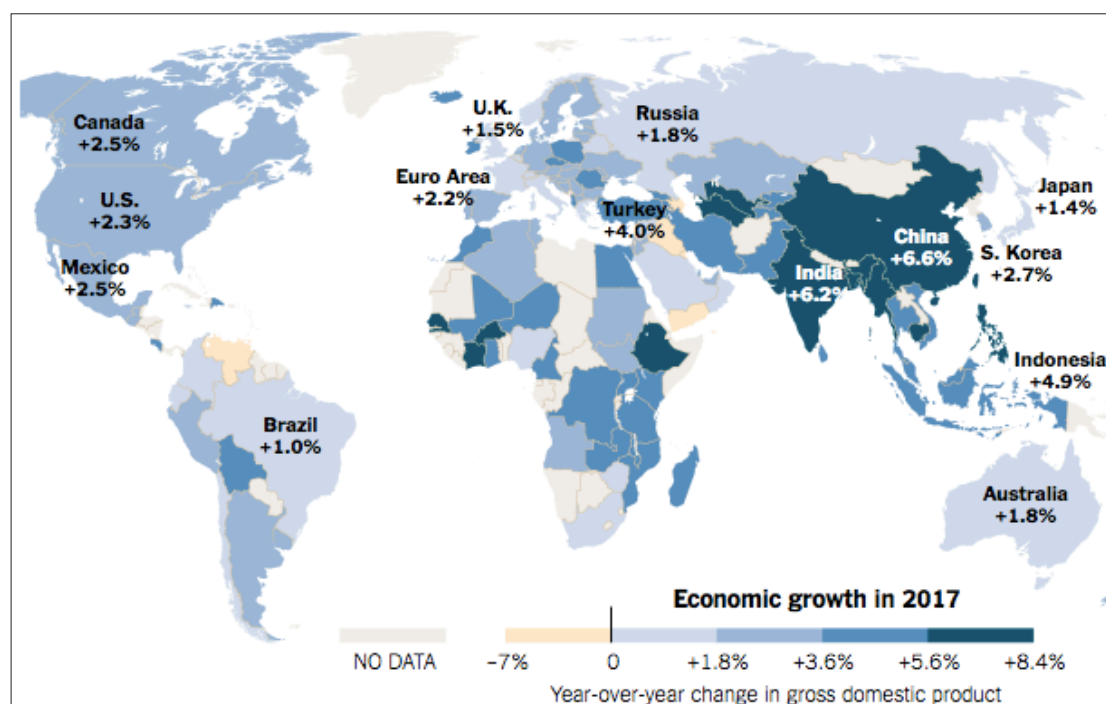
In 2006 Norway pioneered the concept of creditor responsibility for irresponsible lending, when it unilaterally cancelled NOK 520 million of debt for five developing economies that were given poorly assessed loans to indirectly support ship exports from Norway.¹⁷ This and subsequent support from the Norwegian government to the UN has led to a significant development of principles for responsible lending, and has led several NGOs to call for the recognition of the concept of illegitimate and odious debt.

The concept has become newly relevant, as this report shows, in cases such as Chad, Ghana and Mozambique where borrowed funds were corruptly diverted or the borrowing was done on onerous terms. Norway should resume its leadership on the issue and push for an international legal recognition of the principle of irresponsible and illegitimate lending and creditor co-responsibility in dealing with the unpayable debts of these countries.

Norway also played a leading role in the development of UNCTAD's debt workout mechanism and should now advocate for its global adoption as a means to fairly tackle excessive debts build up by poor economies.

CHAPTER 1: INTRODUCTION

After nearly a decade of post-crisis blues following Lehman's collapse in 2008, the global economy appears, at least on the surface, to be back on its feet. In 2017 every major economy grew, with many advanced economies, including the US, the Eurozone and Japan, growing at an above trend growth rate that signified a cyclical recovery - though growth is now expected to normalise in 2018.¹⁸ While emerging economies, particularly China and India, had continued to grow through the post-crisis years, growth has also returned to many poorer economies in Africa that had previously faltered.



Source: *New York Times*¹⁹

While several risks to the economy remain in both advanced and developing economies, growth is expected to continue, offering the global community an opportunity to focus on fixing structural problems. This is also a good time to focus on sustainability in the long-term and to start to deliver on promises made in the Addis Ababa Action Agenda (AAAA), the Paris Summit on Tackling Climate Change, and on Sustainable Development Goals.

This report addresses some of the key issues in Financing for Development (FfD), in particular where the biggest opportunities for actions lie in order to generate funds that would allow middle and low-income countries to invest in sustainable growth, tackle climate change and its effects and, most importantly, meet the SDGs by the target date of 2030. This is not a comprehensive report on the "State of the FfD", a job done well by the forthcoming annual report of the Inter-Agency Task Force on Financing for Development.²⁰

Instead, this is a report that focuses more narrowly on the frontiers, the most important emerging issues in the financing for development landscape that the global community and the Task Force should prioritise over the next few years. These are the issues that could deliver

the biggest bang for the buck in the otherwise sprawling and diffuse discussions on Financing for Development.

The formal FfD ranges broadly over the following topics:

- Aid;
- Domestic resource mobilisation;
- Foreign Direct Investment (FDI) and Portfolio Flows;
- Debt;
- Trade;
- Systemic Issues;
- Science, technology and capacity building, and other cross cutting issues, such as gender and data.²¹

All of these are critical for a successful development strategy. Without trade, for example, productivity would stall. FDI brings much needed skills and capital. Debt, invested wisely, is crucial for development, but over-indebtedness can be stifling for growth.

However, in this short report, we are able to only zoom in on a few of the issues in detail, and tackle others in a more cursory manner. In addition to identifying the most critical topics in terms of their potential impact, we also narrowly focus on those where Norway may have a unique contribution to make.

Thus, this report, particularly in its policy recommendations, focuses on areas where Norway can play a leading role. Using these lenses, the report particularly examines the following:

- The prospects for mobilising financing from the private sector;
- Aspects of Development Finance Institutions and Multilateral Development Bank (MDB) reform;
- Enabling domestic resource mobilisation;
- Dealing with excessive sovereign indebtedness.

These are all areas which are both crucially important, and where Norway has a unique leadership contribution to make to the global agenda and development outcomes.

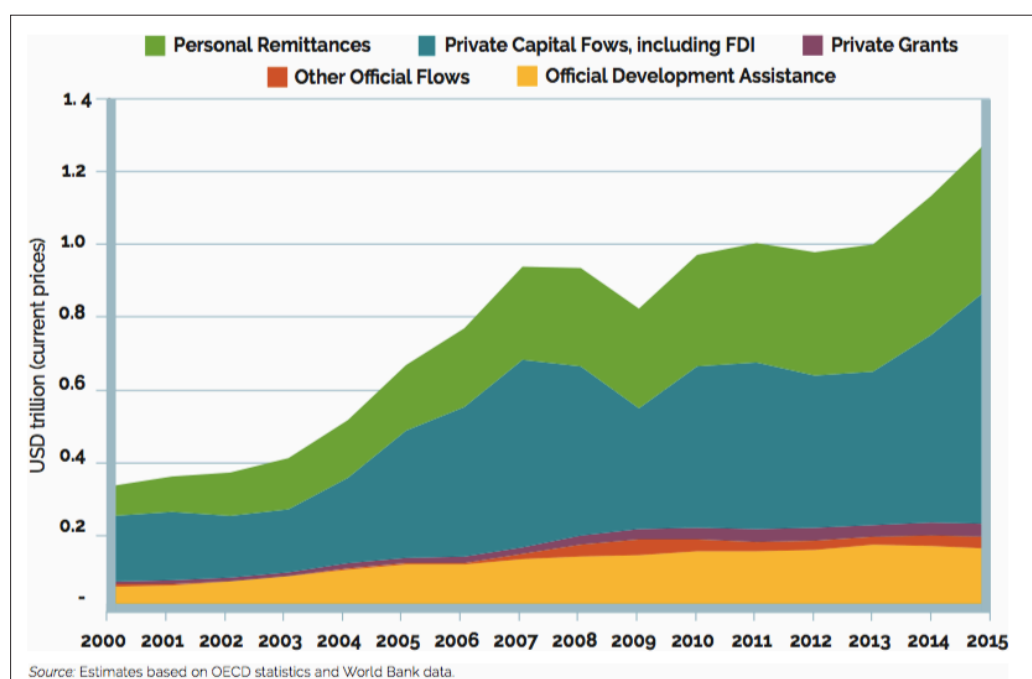
CHAPTER 2: THE STATE OF FINANCING FOR DEVELOPMENT

At a cursory level, there is much to be optimistic about when it comes to the state of the FfD, but on closer inspection, it is a mixed picture.

As highlighted in the previous section, much of the developing world is growing. However, looking at real GDP growth per capita, a better measure for the potential of growth to deliver poverty reduction, one sees that many of the poorest countries are simply not growing fast enough to reduce poverty for the masses.

Moreover, particularly given the emphasis of the Sustainable Development Goals (SDGs) on “leaving no one behind”, it is problematic that many developing economies are seeing a sharp rise in inequality. In a number of other economies, growth is being partly driven by the destruction of the environment, such as the loss of forests and biodiversity, which is unsustainable. In short, far more needs to be done to increase growth rates for the poorest economies and to make sure that such growth is sustainable and equitable.

The graph below captures how the nature of aggregate external net flows into developing economies has changed over the years. It clearly highlights that the biggest potential, at least at an aggregate level, comes from rising private flows.



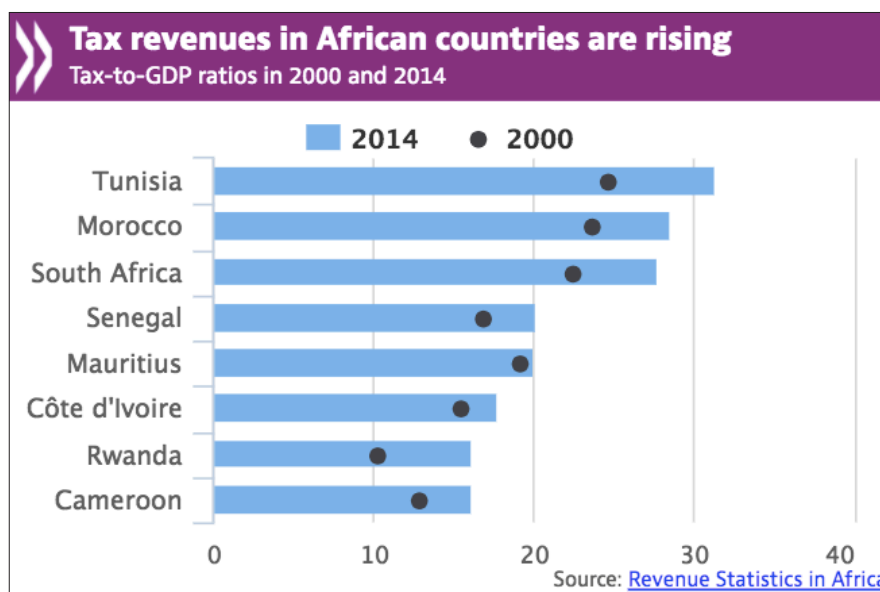
Source: OECD DAC²²

Domestic Resources

While external flows can supplement the resources available to a country, the FfD agenda, from its inception, has rightly put a great emphasis on Domestic Resource Mobilisation (DRM). In the end, it is only these domestic resources that can really deliver sustainable development

over the long term. The most important aspects of these domestic resources are taxes for a government to fund domestic current and capital expenditures, and savings that can help a country invest.

At a cursory level, developing economies across the board have been somewhat successful at increasing tax/GDP ratios over the past decade or so, albeit from a very low level. The LDCs, for example, have increased tax revenue from a median of less than 10% of GDP in 2001 to almost 15% in 2015.²³ The following subset of African countries is indicative of this progress.



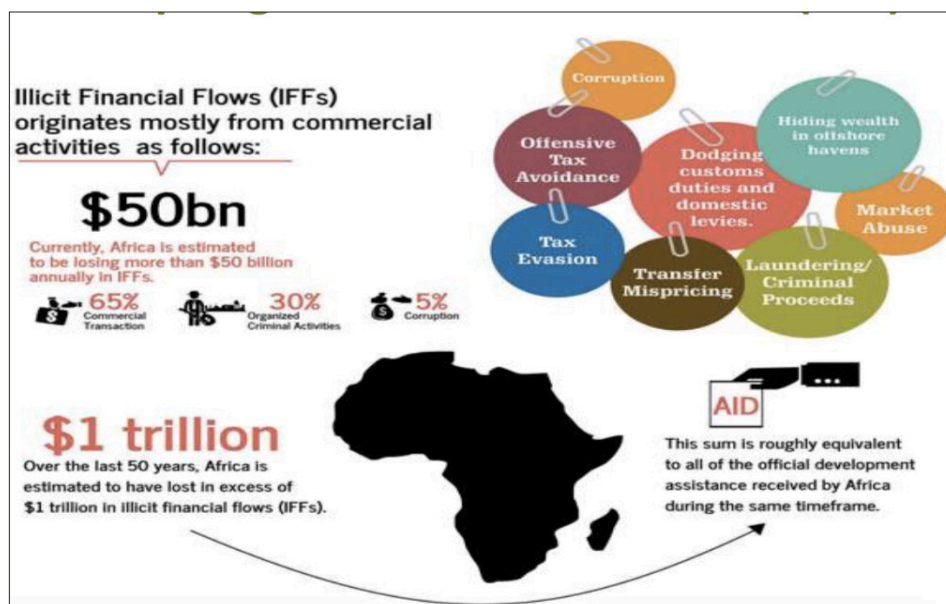
Source: OECD²⁴

However, many of the least developed economies still have tax/GDP ratios of less than 15%, the bare minimum required for a state to function properly. Most developing economies face challenges in raising further revenues, as they are disproportionately dependent on trade and corporate taxes in a global environment where both of these are falling.

Direct taxes such as VAT, which deliver the bulk of revenues in most developed economies, are regressive, a problem in already highly unequal economies. While income taxes are progressive, they can be hard to administer and cannot raise so much revenue in countries where the majority of the population is poor.

Rates of domestic savings have also gone up in most developing economies, though large savings investment gaps remain. Domestic savings also remain low, especially in low-income countries and insufficient to fund the huge needs for investments in infrastructure and beyond. The savings that do exist are often in the informal economy, or have a short tenor and limited risk absorption capacity.

Illicit financial flows (IFFs) further drain already limited tax potential, as well as domestic savings, inflicting losses of more than \$50 billion from Africa alone annually.²⁵



Source: European Centre for Development Policy Management²⁶

Overseas Development Aid

These revenue and saving gaps mean that scant domestic resources need to be supplemented from outside. That is why the role of overseas development aid (ODA) is so crucial.

On this front, there is room for both optimism and pessimism. On the plus side, ODA has been gradually rising as a share of GDP since 2000, but is still only at 0.32%, - less than half of the target of 0.7% that developed economies set themselves in 1970.²⁷ ODA has increased in absolute terms, having doubled from \$71 billion in 2000 to \$143 billion in 2016.²⁸

Another good development has been the rise of non-DAC donors, which are estimated to deliver as much as \$20 billion in concessional finance every year. Adding to that is rising private philanthropy that brings in another \$20 billion - \$30 billion annually.²⁹

However, despite these positive developments, there are several problems that undermine this progress in absolute amounts of aid. The first is that the real increase in aid, adjusted for inflation, has been far more modest. The second is that much of the aid continues to be tied, which reduces its efficacy significantly.³⁰ The third has been the rise in the percentage of ODA that is used in the donor country, particularly on refugees and scholarships. The fourth is that less than 20% of aid that actually makes it to the poorest LDCs. The fifth is the real concern that several NGOs have, that more aid would be diverted to blending with private finance, leaving less for expenditure on pure public projects. Last but not the least, is the concern expressed by several DAC donors that non-DAC assistance is not very transparent.

International Trade

On trade, the picture has darkened recently, following the unilateral imposition of tariffs by Donald Trump that significantly increases the risk of a trade war that the world had largely avoided, despite fears in the aftermath of the financial crisis.³¹ While there have been signs of

rising protectionism, at least in political rhetoric, the world has largely seen a continuation of the fairly liberal trade order that has been in place the past couple of decades. Some major new free trade agreements are being negotiated, including regional ones in developing economies that raise the prospects for south-south trade and regional integration.

However, the increasingly stringent terms of new trade agreements on standards, investor-state disputes and intellectual property may be unduly restrictive for the poorer developing economies that are only now slowly integrating into the global economy. The reality is that many of the policies implemented by economies that have industrialised are no longer available to the low income and least developed economies trying to climb the ladder of development. Another big problem on the international trade agenda has been the drying up of trade finance post-crisis. It has been estimated that the world faces several hundred billion dollars of shortage of trade finance, following the retreat of western banks from many developing economies.³²

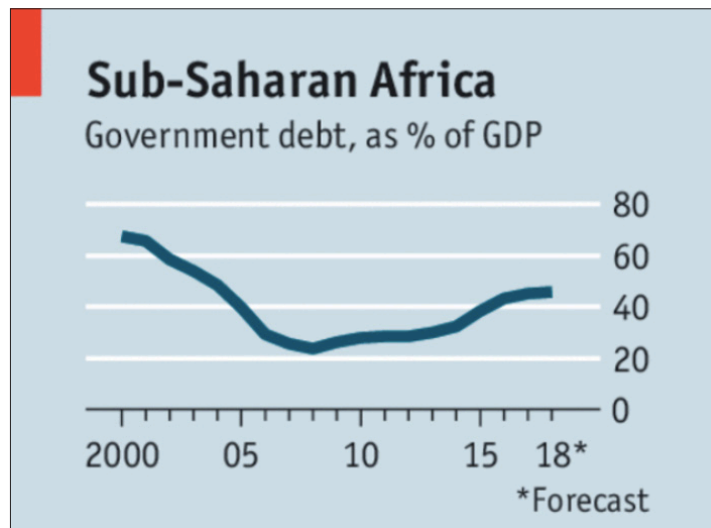
Debt

The post crisis decade has mostly been characterised by benign conditions for developing country borrowing. The continuing fall of inflation across most countries in the world combined with record low interest rates across most of the developed economies and trillions of dollars of quantitative easing to create highly favourable conditions for developing country borrowers.

This has mostly been positive and has enabled governments, corporations and financial institutions across many of these economies to mobilise additional resources for investment. After the Heavily Indebted Poor Country (HIPC) Program (and its successor the Multilateral Debt Restructuring Initiative (MDRI)) helped significantly reduce the debts of vulnerable low income and least developed economies in the late 1990s and early 2000s, many of the same economies were able to borrow again under these benevolent conditions.

For example, lending to Africa surged after the financial crisis, as fund managers chased the high yields of African government bonds and the profits from a commodities boom. The borrowing shifted away from western governments to private finance, with 16 African countries having now sold dollar-denominated bonds to foreign investors. Senegal's \$2.2bn Eurobond in 2018, for example, was five times oversubscribed.³³

However, given that developed economy quantitative easing is now gradually being phased out and interest rate rises have started, the conditions are likely to become decidedly less benign. The shape of the problems that can emerge was seen with the "Taper Tantrum" of 2013³⁴, when yields on emerging market jumped following the first indication of tightening of US monetary policy. The debt burdens of 26 large emerging markets monitored by the IIF rose from 148 per cent of GDP at the end of 2008 to 211 per cent in September 2017³⁵, with corporations accounting for the largest share of the rise.

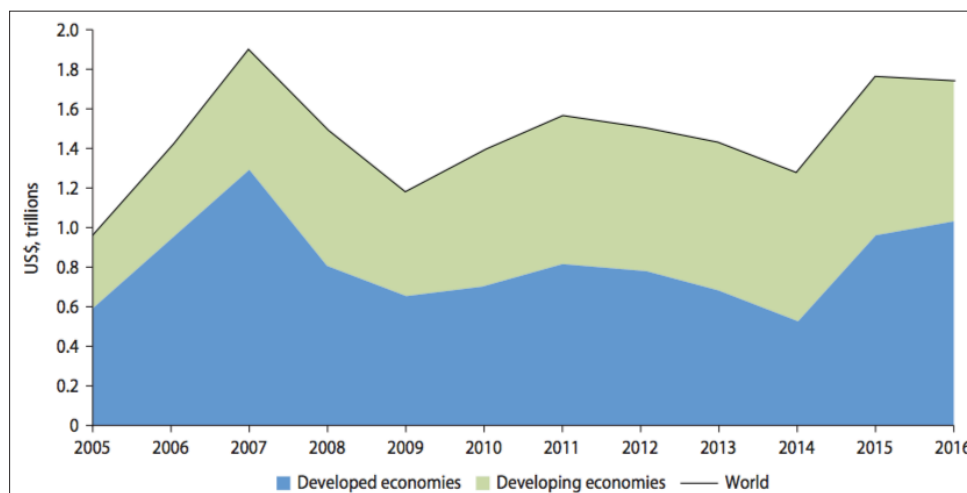


Source: *The Economist*³⁶

As the Task Force acknowledges, debt vulnerabilities have increased across developing countries, in particular in several countries that previously benefitted from debt relief under the HIPC and MDR initiatives. This can be seen clearly in the above graph that charts the rising levels of debt in Sub-Saharan Africa.

Foreign Direct Investment

In prior discussions on FfD, a clear distinction was made between Foreign Direct Investment, which is often in the form of long-term equity stakes and brings valuable positive externalities such as technology transfer and managerial expertise on the one hand, and flightier portfolio flows, that can be easily reversed and hence be destabilising. The good news is that for many developing economies FDI has become the largest external source of financing, exceeding portfolio flows, remittances and overseas development aid. In 2016, for example, more than 40 percent of the nearly \$1.75 trillion of global FDI flows was directed to developing countries³⁷, providing much-needed private capital.³⁸



Source: *World Bank*³⁹

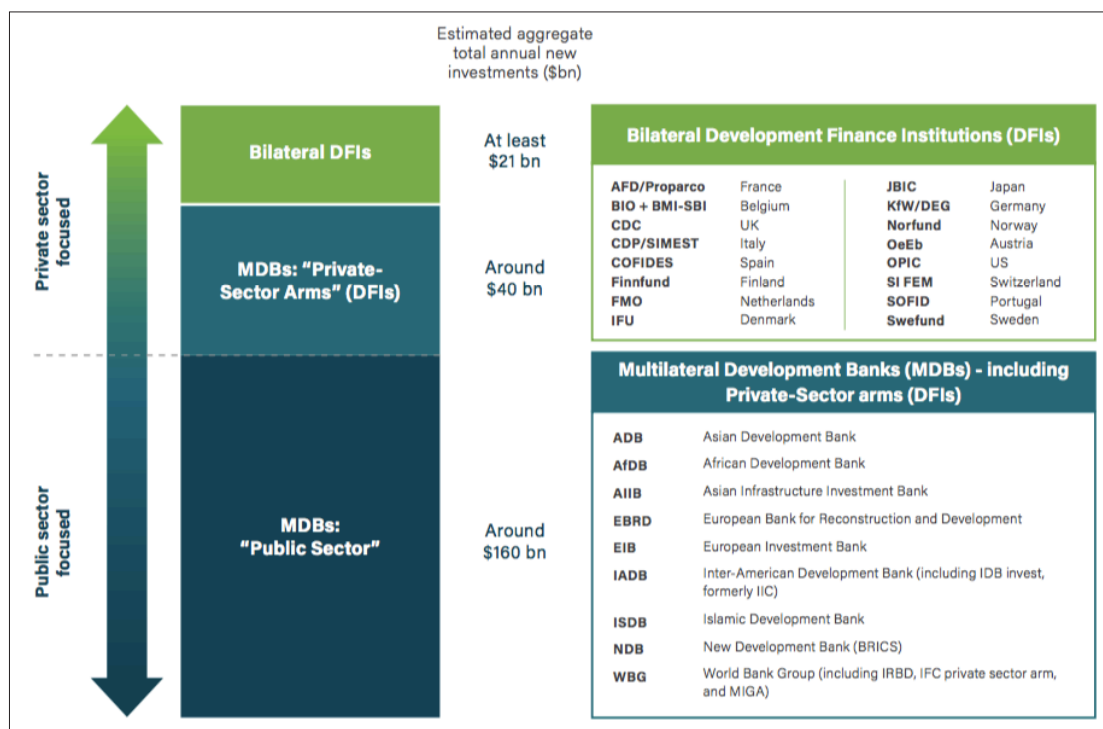
As the World Bank notes, FDI can accelerate productivity gains in host countries. It brings foreign technology and frontier knowledge that, if successfully absorbed by local firms, can improve their productivity directly. FDI can also increase competition among firms in the local market by leading to a reallocation of resources away from less productive to more productive firms, thereby increasing aggregate productivity over the long run.

However, this distribution of FDI is highly asymmetric, with just a few middle income emerging economies accounting for the lion’s share. Fragile and Conflict states (FCS) and LDCs get very little FDI that falls even below their rather limited absorptive capacity. In that sense, countries that most need FDI are not getting enough of it. An encouraging trend has been the rise of South-South FDI, where firms from emerging markets are beginning to enter markets further behind on the development curve.

Another problem with FDI, particularly in low-income countries, has been its concentration in the extractive sector that is not very employment intensive and has relatively limited spillovers into the rest of the domestic economy. Last but not the least, FDI can sometimes come in on highly attractive, even exploitative terms, if the host country has poor institutions and can, instead of contributing to local development, help facilitate a plundering of resources.⁴⁰

Multilateral Development Banks and Development Finance Institutions

Besides these conventional categories, the various MDBs and DFIs also help channel tens of billions of dollars to developing economies every year, both to sovereigns and to the private sector. New MDBs such as the Asia Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB) have recently been established, adding to the overall MDB lending capacity and many DFIs, including the British CDC and the Norwegian Norfund, have seen their capital increase.



Source: Blended Finance Taskforce⁴¹

Against this background, there is a rich ongoing discussion about their role in Global Financial Governance⁴², provision of Global Public Goods and the funding of infrastructure and SDGs. In particular, the MDBs and DFIs are expected to play a critical role in the so-called B2T or Billions to Trillions agenda, which sees a central role for these institutions in helping facilitate the flow of trillions of dollars' worth of private capital into developing economies to fund private investments, infrastructure and the broader SDGs. These institutions are also central to the donor vision of blended finance that envisages that they can help mitigate risk to help catalyze large private sector inflows into developing economies.⁴³

The picture that emerges for middle-income economies is somewhat benign, particularly if they are able to maintain growth, keep raising domestic revenue and navigate the end to record low interest rates. However, the picture for low-income economies, particularly for the LDCs and FCS, is far more difficult.

Overall, there exists an annual funding gap of about \$2.5 trillion that needs to be plugged by the FfD agenda if developing countries are to meet the SDGs.⁴⁴ This gap is far bigger, in percentage terms, for LDCs than it is for Middle Income countries, but both need to act on all chapters of the Financing For Development Agenda if they are to have any hope of meeting the goals by 2030.

CHAPTER 3: THE PRIORITIES OF FINANCING FOR DEVELOPMENT

Given this general backdrop to the state of development finance, it is instructive to look at the state of play on each of these issues, as highlighted by the forthcoming 2018 report of the Inter-Agency Task Force on Financing for Development.⁴⁵ As will become clear in this chapter, there has never been a greater focus by the international community on the role of the private sector in delivering development outcomes.

That is also why the main focus of this report is on mobilising resources for development from the private sector, particularly large institutional investors.

The global economy is growing, but challenges remain

The Task Force acknowledges the opportunity afforded by the broad-based growth in the global economy and urges countries to use the opportunity to enact structural reforms.

It also points to the fact that the headline numbers do not tell the full story. Increased investment after years of underinvestment accounts for about 60% of the acceleration in global growth, but this needs to be supplemented by a broad-based increase in demand. This, the Task Force rightly says, is challenging as wages remain depressed, inequality is rising and growth is unevenly distributed.

The increasingly important role of the private sector

The AAAA recognized the centrality of the private sector as a driver of development through its effect on job creation, increasing productivity, financing of investments and payments of taxes. It calls on businesses to apply their creativity and innovation to solving sustainable development challenges, and invites them to engage as partners in implementation of the sustainable development agenda.

The Task Force documents significant progress on integrating private sector into the FfD and SDG agenda. Private companies are progressively recognizing that sustainability can foster long-term value. The Business and Sustainable Development Commission (BSDC), for example, has found that achieving the SDGs could unlock \$12 trillion in market opportunities across just four sectors: food and agriculture; cities; energy and materials; and health and well-being.⁴⁶

The great promise of institutional investors

In addition to recognizing the need for developing economies to improve business and investment climate with support from advanced economies, the Task Force recognizes the urgent need to improve the incentives of investors and private businesses to make them more long-term oriented, and to align them better with the pursuit of the SDGs. It acknowledges that this would require “a shift to a long-term investment horizon, with sustainability as a central concern”.⁴⁷

It finds that an appropriate interpretation of fiduciary duty would mean incorporating Environment Social and Governance (ESG) factors, but agrees that this is not yet the case. It also acknowledges the need for some regulatory reform that can help incentivise investors to take

the long-term perspective and recognises that consultants, ratings agencies, advisors and others can contribute by apprising risks over the long-term horizon.

It foresees that institutional capital can play a particularly significant role in the financing of much-needed infrastructure.

The Task Force zeroes in on the role and responsibility of asset owners in particular, and urges them to adopt gold standards on responsibility, explore the development of new products such as green bonds, and sees a role for the UN and other agencies to provide a platform for co-ordination and exchange of ideas.

However, even with all these measures, markets may not provide sufficient financing for sustainable development across countries and sectors. Often this would be because not all externalities can be internalized or priced, and where the investments appear to be too risky for private sector actors.

The increasing focus on blended finance

This is where the Task Force acknowledges the importance of risk sharing and mitigation tools such as blended finance, a practice of combining private and public finance in a manner that increases the attractiveness of an investment, often one with big positive externalities to the private sector through juicing up returns or risk reduction through a public subsidy.

There is an acknowledgement of the obvious risks of such an approach, which could involve an unnecessary subsidy, an excessive focus on middle-income countries, and a diversion of scarce aid money away from the most critical public investments in the poorest economies. In particular, the Task Force calls for the development of blending instruments that are particularly suited to the needs of the Least Developed Economies (LDCs).

The important role of DFIs and MDBs

The Task Force also, very importantly, sees an increasing role for DFIs, as well as MDBs to partner with each other, and particularly with the private sector, to help address the differences in risk perceptions by using their local knowledge of conditions in developing economies, as well as to serve a co-ordination function to help pool resources from the private sector.

It also sees an increasing role for National Development Banks (NDBs), particularly in funding sustainable investments.

The role of fintech

Last but not the least, in the financial sector, the Task Force sees great opportunities for financial inclusion through the diffusion and development of fintech and calls for a three-way partnership between fintech entrepreneurs, regulators and multilateral institutions to help develop the best norms for the effective use of fintech in FfD. It also imagines that fintech will play a critical role in reducing the costs of migrant remittances, which can be forebodingly high, particularly for fragile and conflict states (FCS), where they are most needed.

The critical role of domestic resource mobilization

The Task Force foresees that developing economies can benefit from the changing norms on international co-operation, on taxes and on tax transparency, such as automatic exchange of information, and will seek to help developing economies maximize these benefits. It acknowledges that much more needs to be done, particularly to get the poorest countries to benefit from this. In this vein and to address long-standing capacity problems, it calls on donors to increase the share of ODA going to capacity building for domestic resource mobilization.

Norad's Tax for Development program⁴⁸, the joint OECD/UNDP Tax Inspectors Without Borders⁴⁹ and the International Tax Compact⁵⁰ are exactly the kinds of programs that can help the poorest economies increase revenue-raising capacity. The international platform for collaboration on tax can also help the member institutions of the Tax Force pool capacity, particularly on matters of illicit financial flows and international taxation. The Addis Tax Initiative⁵¹, launched in 2015, commits members to double the technical assistance they provide on DRM and to help partner developing countries take full advantage of the Base Erosion Profit Shifting (BEPS) program of the OECD and Automatic Exchange of Information.

The need for a whole government approach to taxation

The Task Force rightly acknowledges the broader aspects of taxation beyond just public revenues and points, in particular, to the need for such systems to be progressive to tackle rising inequality. It speaks of a much-needed whole government approach that also recognizes the role of taxes in setting incentive structures for investments, health outcomes as well as sustainability.

The focus on measuring and tackling illicit financial flows

Another special area of focus is estimating Illicit Financial Flows and looking at measures that can counter these. It also emphasizes the need to build capacity on the recovery of stolen assets, the track record of which thus far has been rather dismal.

Technology can be a double-edged sword for DRM

Technology is yet another area of focus for the Task Force, because of its potential to both capture information flows that can help enhance domestic revenue collection and to disrupt such revenue collection, for example, through the use of digital currencies.

The new demands on ODA may cause a squeeze in LDCs

On the aid front, the Task Force recognizes the need for increased funding for Global Public Goods, one of the themes that emerged from the AAAA. It also follows the Addis Ababa agenda in acknowledging that donors increasingly see the role of ODA as one that is catalytic in helping increase public revenues, as well as private investments into poor economies. The first part focuses on capacity building for DRM, and the second - on innovations such as blended finance and PPPs.

Despite ODA having increased by more than 10% in real terms in 2016, there is a danger that

these newly fangled focus areas for ODA and the urgency of climate mitigation / adaptation funding, which part cannibalizes aid, may reduce the already low proportion of ODA funds that make their way to the most needy LICs and LDCs. The Task Force rightly calls on donors to meet their commitments for increasing ODA, as the logical response to these multi-pronged challenges.

Debt problems may emerge again

As highlighted in the previous chapter, many developing economies have built up significant levels of debt and they may face problems once global interest rates start to rise. Another channel for a debt crisis is a natural disaster or an economic crisis that may strike a country. Future debt problems in at least some developing economies are inevitable, so the Task Force seeks to encourage the use of state contingent bonds such as GDP-linked bonds.

It also proposes a market-based approach with the widespread use of collective action clauses, which thus far only cover less than a third of outstanding developing economy bonds. This needs to be accompanied by a more transparent and simple approach to terms for public sector lending, as well as enhanced developing country capacity on being able to manage borrowing.

Other systemic measures

The Task Force calls for a further development of a multi-layer Global Financial Safety Net (GFSN), with new quick disbursing instruments designed to deal with crisis and disaster-hit countries in particular. It also recognizes the need for better coordination of various parts of the GFSN, enhancing the resources available, better flexibility and embedding counter-cyclicality into disbursements.

Ex-ante risk pooling for disaster management, particularly with built-in incentives for risk reduction, is another priority issue for the Task Force. It recommends that while middle-income countries can self-fund such sovereign risk pooling, low-income countries can get donor assistance for participation.

Other issues

The Task Force rightly emphasizes the positive role that faster technological diffusion can play in helping tackle several developmental challenges, while also enhancing productivity. A related issue is one of innovation systems and the risks of an emergent digital and technological divide between the frontier economies and laggards, as well as within countries between the haves and the have-nots.

A related issue where new technologies and, in particular, big data, artificial intelligence, mobile telephony and digitization can play a particularly important role is in better data collection, more transparency and greater accountability. This can lead to more tax revenues, better access to finance, less corruption, better citizen registration and identity, as well as easier and more efficient access to public services.

CHAPTER 4: THE POTENTIAL OF INSTITUTIONAL INVESTORS

The whole of the FfD agenda is about financial resources that are both domestic and international, and available to developing economies that can be used to fund sustainable development. While traditionally the development debate focussed narrowly on aid, one of the innovations of the FfD consensus in Monterrey was to broaden the discussion to include broader public and private flows, including borrowing, foreign direct investments, portfolio flows, and also domestic resource mobilisation.

Since then, and particularly with the latest iteration in the form of the AAAA, the FfD agenda's focus on private sector flows has only increased. The Task Force on FfD, as seen in the last chapter, sees financial flows from institutional investors and corporations as crucial to supplementing domestic resources in developing economies, especially in the areas of infrastructure and productive investments in the private sector. This is the so-called Billions to Trillions (B2T) agenda.

These flows are also much larger than ODA for most countries. So even small increases in such flows can make a bigger difference to the financing envelope for many developing economies than large increases in aid flows does. However, the two are not, as pointed out earlier, substitutes as they often complement each other. Aid flows remain paramount for both the delivery of global public goods and support of low-income countries.

Another idea that has gained traction, particularly in the past five years or so, is the blending of public and private sources of funds that generally involves an element of risk mitigation or juicing up returns through the use of public funds to help catalyse private sector flows. This idea of using public capital, often ODA money, to “catalyse” or “leverage” public funds is an essential part of the B2T toolkit.

This report focuses on three particular aspects of this B2T agenda:

- the scope for attracting significantly larger amounts of capital from institutional investors to developing economies,
- the role that DFIs in helping facilitate this flow,
- how much commercial capital can DFIs hope to mobilize.

For all of these it is crucial to consider the financial landscape that institutional investors face. Any decisions they may or may not make on investing in developing economies would be informed not just by the risk/return landscape they face in the destination countries, but equally by the risks they face elsewhere, and the prospects for returns. Another way of thinking about this is that investment decisions by institutional investors are determined by both push and pull factors. In this chapter we focus on the first set of push factors.

More than \$80 trillion in long-term institutional capital

A big chill has descended on institutional investors of all shapes and sizes. Pension funds, insurance firms and sovereign wealth funds, which together hold about \$80 trillion in assets, face fragility and a bleak return landscape that is unprecedented in recent history. Of these, roughly

\$39 trillion are held by pension funds and \$30 trillion by insurance firms. The balance is held by sovereign wealth funds, and in the form of excessive central bank reserves.

Prospects for returns are dismal

According to experts, pension funds face an “existential crisis” that is “scary and surreal”. Analysts expect insurance firms “to begin failing”, and sovereign wealth funds and endowments to “face a challenging environment”. Overall, institutional investors worry how it is becoming impossible for them “to create any return at all.”⁵²

This nightmarish scenario has been precipitated by a combination of long-term structural factors such as demographic decline and stagnating productivity, as well as a poor policy response to the financial crisis that left most rich economies with debt overhangs, sclerotic growth, shrinking monetary policy space and elevated political risk.

Most institutional investors, such as Norway’s Oil Fund, are invested mostly in listed bonds and stocks of OECD economies. This exposes them to poor growth, record low interest rates and inflated asset valuations, making generating returns harder than at any time in recent history. Moreover, they are subject to high systemic risk arising from common risk factors of demographic decline, record indebtedness, stagnating productivity and elevated political risk.

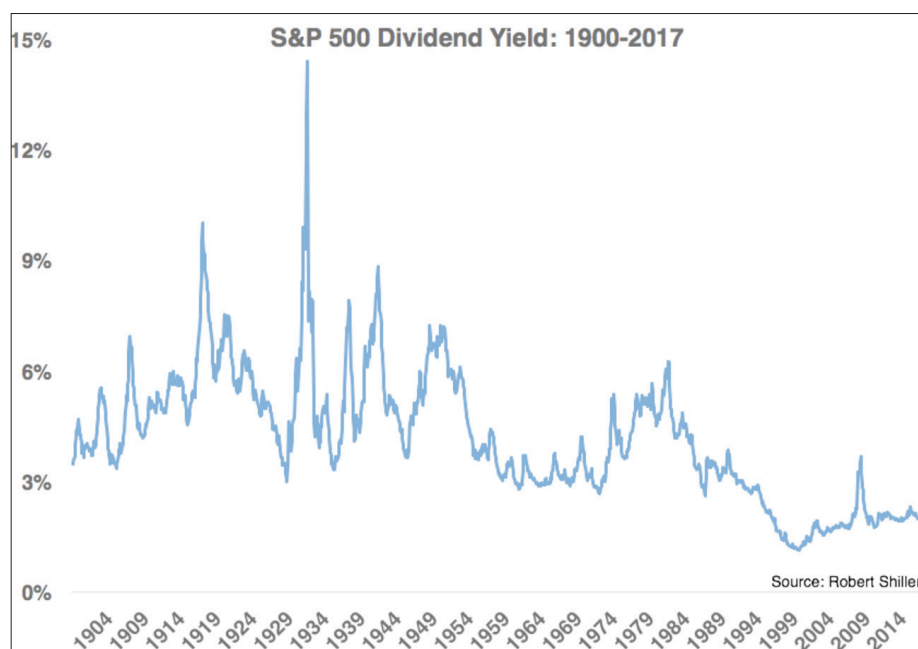
The prospects for financial returns in traditional asset classes are dismal. Of the roughly \$80 trillion worth of Assets Under Management that the institutional investors considered in this report hold, almost 80% is invested in rich country assets, of which roughly 80% is in listed stocks and bonds. The long-term return prospects on these are particularly bleak, as the following table shows. Such investors hold about \$10 trillion of negative yielding assets.⁵³

| LT expected return on OECD portfolios | |
|--|---------|
| SocGen | 1% |
| LBS | 2%-2.5% |
| AQR | 2.4% |
| Norway's SWF | 3% |

*Source:Re-Define, 2018*⁵⁴

Historically, a balanced portfolio of rich country stocks and bonds has generated good returns. For example, SocGen finds that the medium term real returns on such portfolios in the mid-80s were around 8%, but have fallen precipitously since to 3% in the mid-2000s, to just 1% now. The London Business School is a bit more optimistic, calculating that real return in the foreseeable future to be around 2%-2.5%.⁵⁵

AQR, a hedge fund places the number at 2.4% and analysis from the McKinsey Global Institute and Aberdeen Asset Management support these poor prospects based on their analysis. The Norwegian Sovereign Wealth Fund has the most optimistic estimate at 3%.⁵⁶



Source: Bloomberg View⁵⁷

Stock market yields are also at near record low levels, as the graph above shows. Yields in other developed country stock markets are not much higher than what is available in the S&P 500, even though the actual yield increases somewhat once buybacks are taken into account. *Such poor return prospects can spell disaster for such investors.*

For most large pension funds, which include US behemoths such as CALPERS and CALSTERS, Dutch giants ABP and PGGM, and the Swedish APs, the bulk of their present corpus is accounted for by accumulated financial market returns, not new pension contributions.

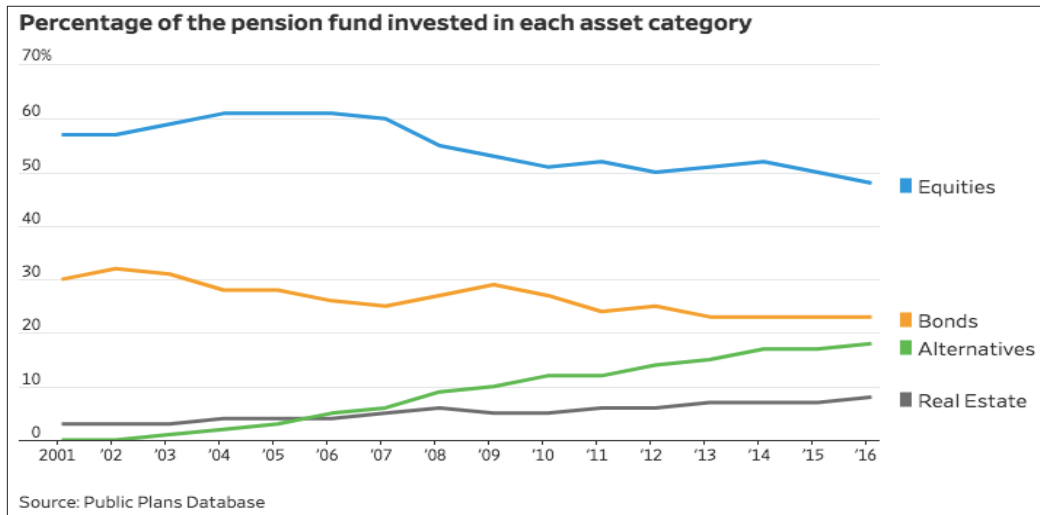
Of the \$5.9 trillion of revenues of American public sector pension funds since 1984, for example, \$3.7 trillion came from financial market returns. Even many sovereign wealth funds such as the Norwegian Sovereign Wealth Fund (GPIF), ADIA and the GIC can attribute the majority of their current corpus to accumulated financial returns.

Half or more of these returns came in the form of capital gains in a world which saw a more or less secular decline in US interest rates from 9.83% in the 1989, down to near zero in 2009 (rising up to 1.42% now)⁵⁸. As interest rates start rising to more normal levels, the capital gains could easily turn into capital losses. We may have seen some of the potential for losses in the stock market volatility and losses seen in the beginning of 2018.

In summary, these funds are highly dependent on high returns from financial markets, so they are unprepared for the poor returns and potential for capital losses that now confronts them. This has driven investors to venture ever further geographically as well in trying out new, sometimes exotic, asset classes. That is why investments in alternatives have reached record levels, as illustrated by the table and graph below.

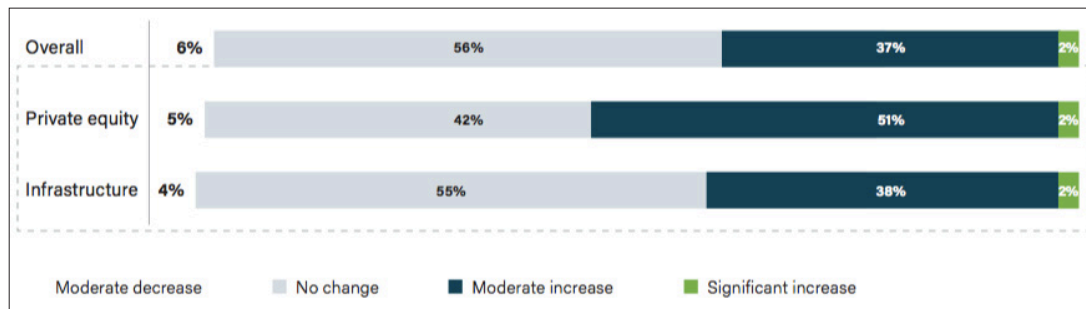
| | 2002 | 2007 | 2012 | 2014 |
|---------------------|--------|--------|--------|--------|
| Private Markets | 15.40% | 16.20% | 25.70% | 27.50% |
| Listed Equities | 36.30% | 40.00% | 41.00% | 37.60% |
| Listed Bonds & Cash | 48.30% | 43.80% | 33.30% | 34.80% |

Source: State Street Global Advisors⁵⁹



Source: Public Plans Database⁶⁰

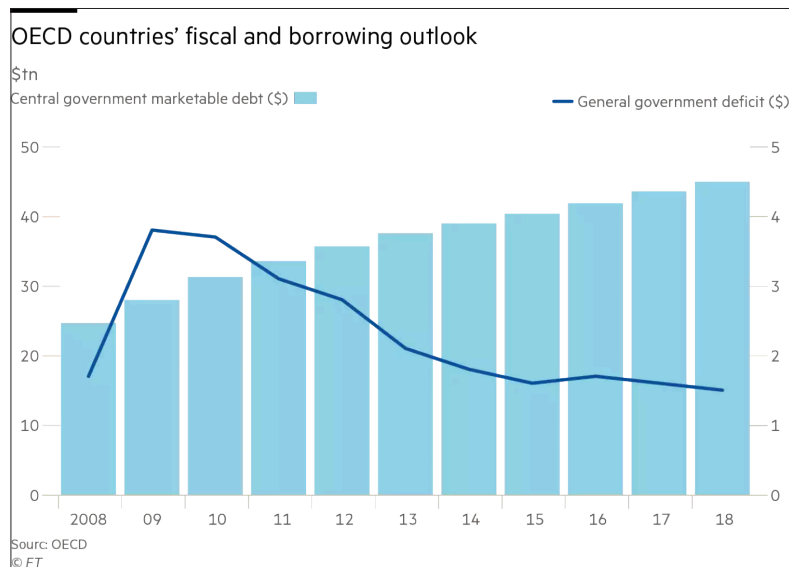
Most investors, as the following graph shows, are looking to increase their allocation to alternatives further or to keep it at present levels.



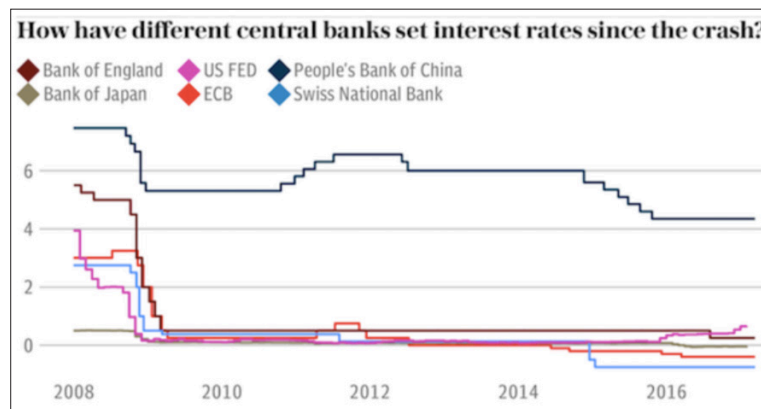
Source: Business and Sustainable Development Commission⁶¹

Risks for OECD investments are high and potentially rising

Not only is the prospect of low returns with a bias towards additional capital losses bad, but it is made worse by the fragility that increasingly characterizes many developed markets. The ability of developed country governments to be able to respond adequately with counter-cyclical policies to any future financial, economic and political shock is highly suspect, given the far more constrained fiscal, monetary and political space they have (as illustrated by the three charts below). These have also made good policy responses to the longer-term structural problems less likely.



Source: *Financial Times*⁶²



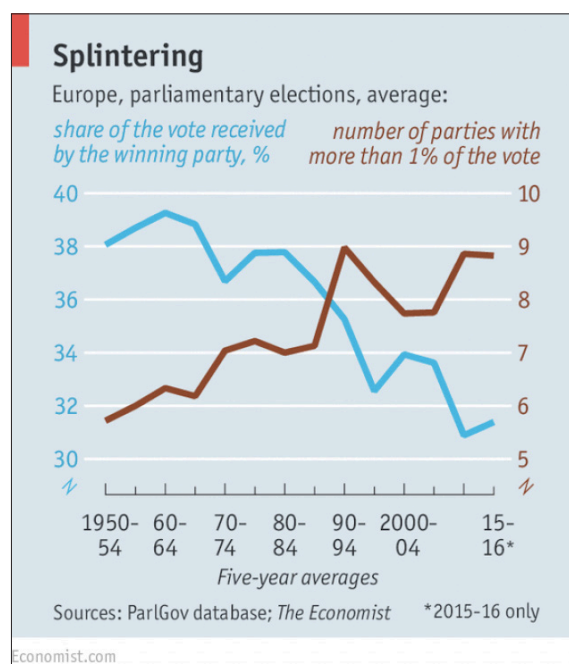
Source: *Re-Define*

OECD economy governments, as the first graph shows, have borrowed heavily, with their sovereign debt stock having risen from \$25tn in 2008 to more than \$45tn in 2017.⁶³ Eurozone government debt to GDP ratio today is more than 20% higher than in 2008.⁶⁴ For Japan the figure is 60%⁶⁵, and for the USA almost 40%⁶⁶. Room for countercyclical fiscal policy today is highly constrained now.

Meanwhile, interest rates throughout the developed world have fallen to record low levels in the past few years, as the second graph shows. In each of the past few major recessions, the US Fed cut interest rates by around 5%. Clearly, were another financial or economic shock to hit the developed world now, there is no such room left for countercyclical monetary policy.

In parallel to these developments, populism has risen in much of the developed world, as evidenced not just by the election of Donald Trump in the US and the Brexit vote in the UK, but also by the increasing fragmentation of the political centre. The graph below captures part of this phenomenon for the EU. The outcome of the recent Italian election, which saw the rise of populist parties, is yet another case in point.

This means that most OECD economies today have far less monetary, fiscal and political space than they had in 2008, when many were able to take decisive action in response to Lehman's collapse. This makes for a high degree of underlying fragility.



Source: *The Economist*⁶⁷

The search for yield and diversification is on

Many institutional investors thus find themselves locked in a low return world, which explains why there is a desperate search for new geographies as well as asset classes and investment strategies that could potentially generate higher returns.

At the same time, they also face an urgent need to diversify. Not only is there a high degree of underlying fragility in many of the OECD economies that these institutional investors are most exposed to, many of these economies have a very high degree of financial and economic inter-linkages. In addition, most OECD economies face similar structural risks arising from unfavourable demographics, debt overhangs and slowing productivity.

The only way institutional investors can substantially improve the risk-return characteristics of their portfolios is by seeking asset classes and economies that are structurally different from most OECD economies, and where higher financial returns can be expected in the long term based on prospects for faster growth.

Many emerging economies, as well as a number of low-income countries qualify, given their favourable demographics and potential for technological catch up. In addition to this, many developing economies have significantly improved their governance and macroeconomic policy management. Corruption has also fallen across many countries and political risks have also fallen across large swathes of the developing world.

In short, there could hardly have been a more propitious time for advancing a core part of the

FfD and B2T agenda – getting institutional investors to reallocate significant parts of their portfolios towards developing and emerging markets across a series of asset classes that includes, in particular, infrastructure and private equity.

The table below summarizes the average returns of some of the world’s largest institutional investors. This serves as a rough benchmark for the kinds of minimum returns they would seek from investing in developing economies, though most would add a premium for what is generally perceived to be higher risk.

| Nominal Return | 5 year | 10 year | 20 year | Since Inception |
|-----------------------|--------|-----------|---------|-----------------|
| GIC | 3.70% | 5.00% | 5.70% | |
| ADIA | | | 6.10% | |
| CIC | | | | 4.76% |
| KIC | 5.11% | | | 3.34% |
| SOFAZ | 1.72% | 2.19% | | |
| GPIF | | | | 5.90% |
| KIA | | | 7%-8.5% | |
| ABP | | | 7.00% | |
| AP Funds | | 4.3%-5.7% | | |
| CALSTRS | | 5.60% | | |
| CALPERS | | 6.20% | | |
| Canadian Funds | | 5.6%-7.3% | | |
| University Endowments | | 5.7%-8.2% | | |

Source: *Re-Define*⁶⁸

These are mostly nominal returns, so real returns are on average about 2% lower. The first thing to note is the wide dispersion of returns with SOFAZ on one end of the spectrum, and the Canadian funds, ABP and University endowments on the other.

This means that risk-adjusted real returns of between 3%-5% would already be interesting for a number of institutional investors, if not from the perspective of yield seeking then definitely from the perspective of risk diversification. This is important and puts these returns well within the target range of returns that various DFIs have generated over decades.

CHAPTER 5: THE POTENTIAL OF DEVELOPMENT FINANCE INSTITUTIONS

This is a particularly good time for DFIs to mobilize capital

This trend of a search for both yield and for diversification, seen amongst institutional investors, has combined with a surge in SDG-related, ESG and impact investing. It has driven institutional investors' growing real and latent interest in all asset classes in emerging and frontier economies.

However, most of the institutional investors lack the local specialist knowledge and the human capacity to be able to invest in these economies, particularly in unlisted asset classes, where the biggest economic opportunities lie. Most will only be able to invest through or in partnership with a local partner which has deep domain knowledge, a good track record and, increasingly importantly, good ESG credentials.

For a growing category of investors, seeking to make a positive impact with their investments is as important as generating a good return. Some are even willing to forego some financial return in exchange for a larger impact.

Given this context, Development Finance Institutions, the original "impact investors", are a perfect partner for investors seeking to dip their toes in unfamiliar developing economies. Many of the DFIs that specialize in private sector development in developing economies have a track record of several decades, and unparalleled domain knowledge about the investing landscape and business opportunities in developing economies, including LICs and LDCs. CDC, for instance, was set up in 1948 and the IFC in 1956.

All DFIs have a dual-mandate of the kind that is core to all impact investors and also increasingly popular amongst more mainstream ESG investors. Their dual mandate is to generate financial returns as well as have a positive developmental externality in the form of job creation, market creation or positive environmental impacts.

Taken together, all DFIs make about \$60-\$70 billion of loans, guarantees and equity investments every year, of which the IFC, which has offices in more than 100 countries, does \$12-\$15 billion and the European Development Finance Institutions, EDFIs, about the same.⁶⁹

While some of the institutions such as the IFC and FMO can borrow, so they are able to already channel institutional capital into investments in developing economies, others such as CDC and Norfund can only invest their own capital. They too, as we will see later in this chapter, are able to mobilize institutional capital, but directly into their investments rather than through their own balance sheet.

DFIs use different instruments, and have different sector and geographic focus

Overall, the largest share of DFI investments happen in form of loans, with some such as the US OPIC that are only allowed to make loans, not any equity investments. Others, particularly CDC, focus mostly on equity. CDC's equity portfolio, for example, splits roughly equally between fund investments in private equity funds and direct investments in companies. In the

past, CDC has helped seed and launch the private equity industry, particularly in South Asia and Sub-Saharan Africa and it remains on the lookout for promising new managers.

Private equity in these economies is often very different from that in developed economies, where a lot of the focus is on Leveraged Buyouts and many of the firms have been listed or are on the path to listing. In developing economies, particularly poorer ones, many private equity investments happen in smaller and medium sized firms, for many of which listing is not on the horizon. In that sense, private equity of the kind that DFIs often invest in is less about financial engineering and much more about delivering capital to the real economy.

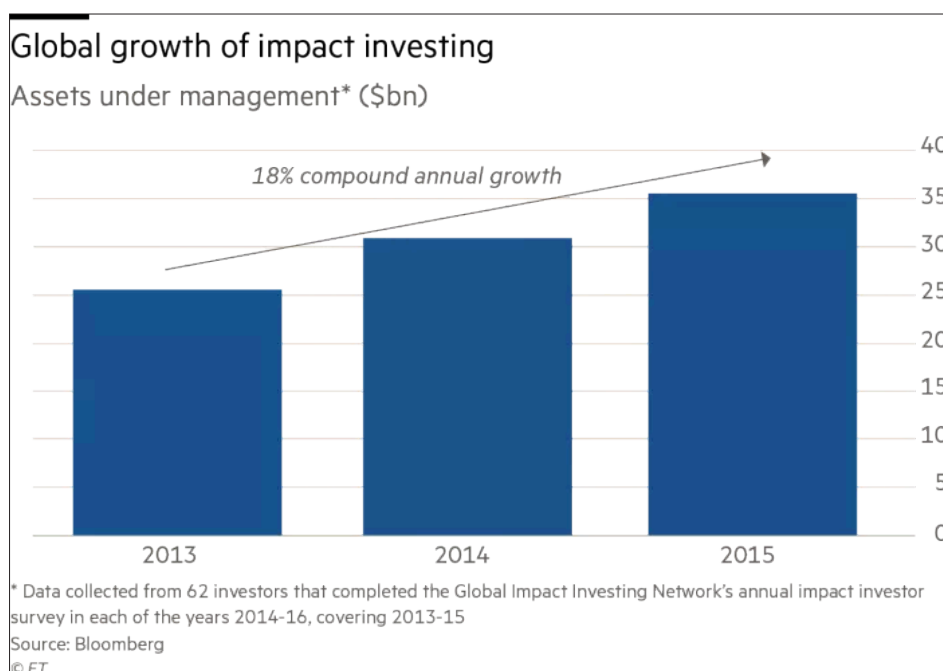
Overall, the various DFIs have built up different domains of expertise. For example, the IFC has by far the largest local presence and the biggest, most well diversified portfolio. But in many countries some of the bilateral DFIs, such as the Dutch FMO or the German DEG, may have bigger portfolios. Many of the DFIs, particularly the IFC, have come under criticism for focusing far too much of their investments in middle-income countries⁷⁰, where the scarcity of capital is less severe than in low-income economies. Others, such as CDC, focus almost exclusively on LICs and LDCs.⁷¹ Over 44% of CDC's investments in 2016 went to Fragile and Conflict states, over twice the average for DFIs. While the biggest sectors for DFI investments are finance, utilities and manufacturing, different DFIs have different sector priorities and mixes. Overall, while there are some overlaps, there is also a reasonable amount of differentiation across the various DFIs.

This means that investors looking to partner with DFIs can choose from a number of options, depending on what exactly they are after in terms of a particular geographic, asset class or sector focus. Some of the DFIs, in particular the IFC, the EBRD and the FMO have already established partnerships with institutional investors to channel their capital into developing country investments. Others, such as CDC, are looking to set up such partnerships in the next few years.

The timing for such a mobilization effort is fortuitous, as it comes at a juncture that, as highlighted in the previous chapter, institutional investors are increasingly seeking such partnerships from the perspective of enhancing returns, increasing diversification, delivering on ESG commitments and generating impact.

For example, the Global Impact Investing Network (GIIN) estimates that on a conservative basis there is more than \$114 billion invested in a manner that takes a broader non-financial positive impact into account. When TPG, a private equity group, sought to raise \$1.5 billion for an impact investment fund, it received overwhelming interest that led TPG to raise the size to \$2 billion.

A partial survey of some major impact investors by the GIIN showed a rapid growth rate of 18% pa. This includes DFI capital, but that too is increasing. DfID, for example, has promised to double CDC's capital within the next few years.



Source: *Financial Times*⁷²

How DFIs mobilize capital

There are several approaches to defining mobilization, none obviously superior to all of the others. Broadly speaking, and for the purpose of this report, mobilization can be understood to be the additional capital contributed to a country/sector/fund/company driven, directly or indirectly, by a DFI's presence and involvement. We understand that establishing causality and trying to capture this quantitatively is a hopeless endeavor, but nevertheless this is a useful analytical lens to use.

In some sense then, a proportion of all the funds mobilized by private equity in the economies where DFIs helped launch the industry can be attributable to the DFI's presence and actions, past or present. In a narrower sense, mobilizations by those fund managers the DFI has seeded, or helped with the launch of their first funds, are more directly attributable to the DFI's actions. A DFI's presence in a country or a sector may be considered to have reduced information asymmetry, had a demonstration effect, and developed or matured the private sector landscape in a manner that has reduced both the perceived and actual riskiness for investors, as well as increased the scope for profitability.

Through direct investment, a DFI's vote of confidence can crowd in other investors that look at DFI involvement as a stamp of approval, given their strong brand names, reputation for quality due diligence and a modest degree of political risk insurance.

A broad distinction, first and foremost, is perhaps between direct and indirect mobilization. Direct mobilization is limited to cases where a DFI has a direct financial stake, and indirect mobilization will capture all other second order effects discussed above. Below we take a stab at a typology of mobilizations, which is critical to understand the change model and mobilization potential of DFIs.

| A Typology of Capital Mobilization by Development Finance Institutions | |
|--|---|
| Mobilization | How it Works |
| Pre-Mobilization | In anticipation of DFI participation |
| Co-Mobilization | Investing alongside a DFI on identical terms |
| Post-Mobilization | Investing in follow-up PE fundraising rounds |
| Exit-Mobilization | DFIs selling out to commercial investors |
| Senior-Mobilization | Investing alongside more junior/concessional capital |
| Sub-Mobilization | DFI offering junior/concessional terms to attract capital |
| Catalytic-Mobilization | New fund/initiative/partnership which catalyses mobilisation |
| Intro-Mobilization | DFIs leveraging their contracts to connect investees to sponsors |
| Info-Mobilization | DFIs promoting sector/country through data/opportunities/myth-busting |
| Demo-Mobilization | DFI involvement in projects to demonstrate viability and profit opportunities |

*Source: Re-Define*⁷³

The relative importance of all of these aspects of mobilization will vary across product lines, sectors and geographies.

It is very important in the discussions on the role of DFIs in mobilizing private capital that all of these aspects of mobilization are considered. After all, what really matters for development is the quality and quantity of capital that is mobilized, not whether a particular DFI gets credit for it or not.

There is a lot of scope for mobilization of private capital and we see an evolution of the role of DFIs away from the provision of capital towards the facilitation of capital.

Some Examples of successful DFI mobilization

The IFC's Asset Management Company (AMC)

In 2009, in the immediate aftermath of the financial crisis when developing country financial institutions came under stress because of the spillovers of Lehman's collapse, the IFC set up a co-investment vehicle, the Asset Management Company (AMC), where it invited institutional investors to co-invest alongside the IFC's own equity team. Since then, the AMC has grown from strength to strength and has now mobilized over \$10 billion of investments (\$7.5 billion, excluding the IFC's own capital) from over 55 investors.⁷⁴

The AMC, which has its own investment committee, has access to the IFC's own pipeline and typically chooses about one of every three investments it sees. This selectivity is important to institutional investors. For the IFC, the co-investment frees up capital that it can deploy to enhance development impact elsewhere. Up to date, a number of investors, both government and private, have co-invested. The following list, which is not complete, nevertheless paints a good picture of the kinds of co-investors the IFC has managed to attract for its equity investments. In the typology of the previous section, these are at the same risk level as the IFC so are defined as co-mobilizations.

- Development ministries and agencies from countries such as Japan, the UK, Canada and Norway: JICA, DfID, CIDA, MFA respectively;
- MDBs and DFIs such as AfDB, EIB, OFID, ADFD, JBIC;

- Sovereign Wealth Funds from Singapore, Azerbaijan, Korea and the Middle East amongst others such as the GIC, SOFAZ, KIC, ADIA etc.;
- Pension funds such as PGGM from the Netherlands, the Tfl Pension Fund, the UN Joint Staff Pension Fund and GPIF from Japan;
- Insurance firms such as Dai-ichi Life of Japan.

The IFC also has an extensive mobilization and syndication program for its debt operations, but this is mostly done under the IFC's own name and is expected to have preferential creditor treatment, so it does not add much in the way of genuinely risk absorbing capital for the recipient state.

The EBRD's Equity Participation Facility (EPF)

The EBRD recently launched an Equity Participation Facility (EPF), wherein institutional investors will get a 20%-30% exposure to all new equity investments above €10 million through a swap arrangement, and the EBRD will retain the residual 70%-80% stake.⁷⁵

The EPF has completed a first successful round of fundraising with €350 million of capital raised from two cornerstone institutional investors, China's State Administration of Foreign Exchange (SAFE) and the State Oil Fund of Azerbaijan (SOFAZ), with the final target size of the fund being between €750 million and €1 billion. Investors in the fund are completely passive and follow the EBRD's investment process, but will be presented with a liquidity sweep exit arrangement at the end of the Fund's life.

The AsDB's PINAI

The Philippine Investment Alliance for Infrastructure (PINAI) is a private equity fund dedicated to investing in Philippine infrastructure that was launched jointly by the Asian Development Bank, GSIS – the Philippine state-owned pension fund, Macquarie Group and the Dutch pension asset manager APG.⁷⁶

The fund, launched in 2012, has a corpus of \$625 million and is managed by MIRA, Macquarie Infrastructure and Real Assets, on behalf of its owners. The fund has a four-year investment window and has invested in a number of assets that range from light rail transit, to coal fired power plants, solar power plant, a pipeline and a wind farm.

The fund, which was initiated by the Asian Development Bank, aligns the interests of the institutional investors and the manager by having required the manager to co-invest alongside the other investors. Three cornerstone investors make up the fund, the Government Service Insurance System fund (\$400m), the Asian Development Bank (\$25m), and the Dutch pension fund asset manager, APG (\$150m). After a thorough manager selection process, Macquarie Infrastructure and Real Assets (MIRA) was selected to manage the fund and will also provide equity into the fund (\$50m). The total size of the fund is \$625 million.

KLP Norfund Investment AS

In 2013, KLP, Norway's largest life insurance firm and Norfund, the Norwegian DFI, agreed to co-invest in the finance and clean energy sectors in emerging markets. Hence, KLP Norfund Investment AS (KNI) was established with an ownership of 50% each.⁷⁷

Norfund and KLP agreed to invest NOK 500 million each over a five years period. They agreed that the investments should be based on commercial risk and return considerations, as well as setting high standards for environmental and social issues.

The Joint Venture invests equity in selected renewable energy projects within Norfund's investment strategy.

CHAPTER 6: WHAT NEXT FOR DEVELOPMENT FINANCE INSTITUTIONS

As the discussion in the previous chapter has made clear, if implicitly, the quality of capital mobilized is also important, not just the quantity. This chapter builds on that and extends the analysis to the kinds of investors that DFIs should seek to mobilize, and the amount of mobilization of capital to target.

Which investors DFIs should seek to mobilize

What developing economies really need is genuinely risk-absorbing capital. In that sense, capital that is mobilized at the same risk level as the DFI, or where relevant, subordinate to the DFI, is more valuable, dollar for dollar, than capital mobilized senior to DFI's own investment. Thus, the default mobilization strategy should always be for co-investment alongside the DFI, with senior claims an exception that ought to be justified. DFI provision of guarantees and first loss or other forms of subsidy should be rare, and need special approval from the investment committee and development impact team.

The logic behind that is that taxpayer subsidy should be rigorously justified. Subsidies can distort the market for commercial investors, as well as damage the DFI model. They undermine the sustainability of investments, so should be used only when there is a strong development imperative and a clear path to commercial viability. A clear cascade/waterfall approach can provide good discipline here. Capital should be mobilized at the lowest level of the cascade/waterfall in terms of concessionality, or the lowest level of seniority before moving to a higher degree of concessionality or more senior tranches. This move should be justified in the form of a higher development impact.

In that sense, investors with deeper pockets, a high tolerance for risk, low need for liquidity, and with strong internal investment expertise would be the most desirable partners. There is, given the additional benefits from the development of local capital markets, an even greater case to priorities domestic and regional investors such as pension funds and sovereign wealth funds. They also come with yet another big advantage – funding in local currency.

Ideally speaking, even while setting and maintaining quantitative targets, the mobilization teams at DFIs ought to also have matching qualitative targets in terms of the quality of capital mobilized and a preferential list of investors to target for mobilization, aimed at maximizing development potential in the long term. The table below summarizes the characteristics of the most desirable investors.

| ----->-----More Desirable ----->-- | | |
|------------------------------------|--|---------------|
| Small | | Big |
| Short-Horizon | | Long-Horizon |
| Passive | | Active |
| Naïve | | Sophisticated |
| Risk Averse | | Risk-Tolerant |

In general, a DFI should find it easy to attract the investors they have already invested with. Attracting investors who have invested in emerging market/frontier Private Equity (PE), but

not with the DFI in question, would be somewhat harder. Getting investors who have emerging market exposure, but only in listed investments, to take on PE exposure would be somewhat harder still. Trying to attract investors who are familiar with PE, but have not invested in emerging markets before to invest alongside a DFI would require a lot of education, reassurance and effort. Getting investors who neither know PE as an asset class, nor have any geographic allocation to emerging markets to make the leap would be hardest of all.

To maximize the long-term development impact, a DFI should try to make sure not only that the development impact of the project is high, but also that the DFI's own intervention needs to be temporary and that the investment is financially sustainable after the DFI exits. Similarly, on the mobilization front, a DFI ought to try and make sure that the investors it seeks to mobilize are likely to continue their involvement in the country and sector, even after the initial partnership or investment with the DFI has ended.

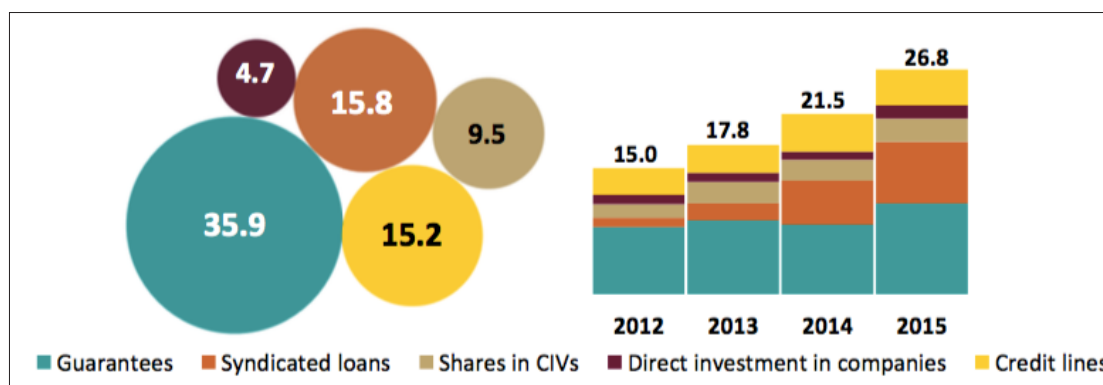
How much should DFIs seek to mobilize

Based on increasing examples of successful co-investment strategies, the rising supply of capital, the existing pipelines of the leading DFIs and conversations, with the top management of DFIs including the EBRD, the IFC, Norfund, FMO and CDC, we estimate that it should be possible to get at a 2 X mobilization factor of co-mobilization.

This can be possible with new partnerships, much additional effort, new prioritization of mobilization and some additional staff - without diluting the quality of the pipeline too much within the next 2-3 years. This means that between the IFC and the EDFIs it should be possible to mobilize as much as \$40bn of additional private sector capital. Yet this is still a long way from the trillions needed to fund SDGs.

If a much broader definition is used, then much higher levels of mobilizations can be attributed to DFIs, but any reasonable measure will still be very far from the trillions needed.

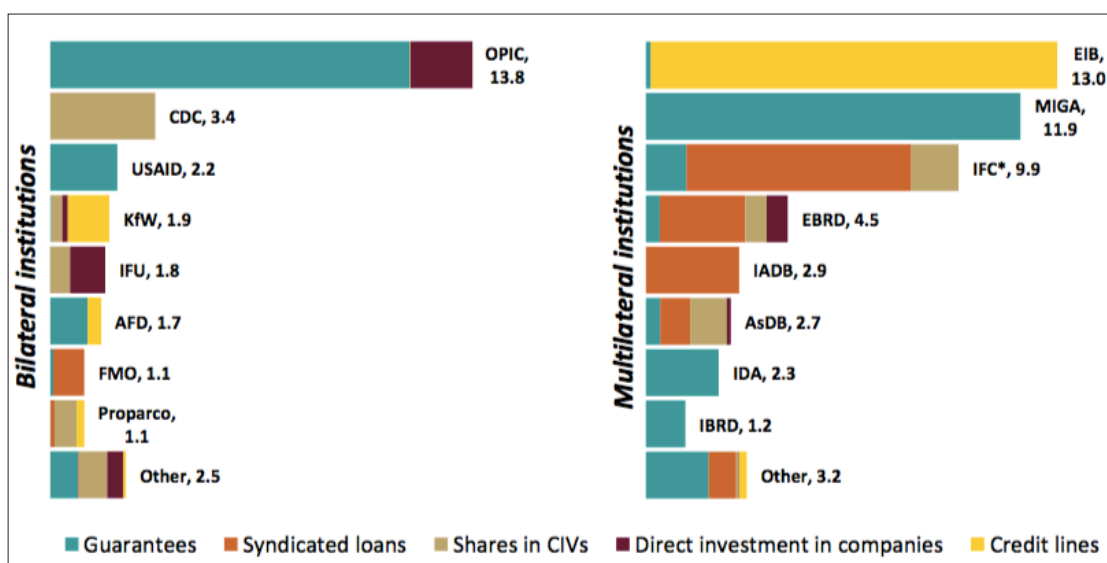
Using a very different measure of mobilization, and a different approach that treats guarantees, debt and credit lines at par with investments in private equity and direct equity investments and using a much bigger universe than the DFIs we have focused on, the OECD DAC has made the following estimate for mobilization of commercial capital from 2012 to 2015.



Source: OECD DAC⁷⁸

This is roughly consistent with our estimates for mobilization potential, but it also makes the trade-off between the quality and quantity of capital mobilized clear. This issue lies at the heart of the discussion on blended finance.

The next graph paints an even clearer picture. Once one strips away the credit lines from the EIB and OPIC and MIGA guarantees, the amount of capital mobilized collapses. This is not to say that credit lines and guarantees are not important, they are, but to merely show that not every dollar of capital mobilized is the same. Every additional dollar of commercial capital in the form of risk absorbing equity is harder to mobilize than an equivalent amount of credit lines.



Source: OECD DAC⁷⁹

As DFIs seek to shift their business models away being providers of capital towards facilitators and catalysts that seek to maximize the flow of external private capital to the private sector in developing economies, they could significantly enhance their mobilization, but this will take time.

It also means, for example, that DFIs, should not seek to hold on to successful profitable investments as they do now, but should seek to offload these to the private sector. This will mean a higher turnover in the portfolio, but focus scarce resources towards the creation of a pipeline for new deals, and increase private sector mobilization.

How DFIs can prioritize the mobilization of commercial capital

All DFIs should build up dedicated mobilization teams that will seek to maximize the quality and quantity of commercial capital mobilized. This would entail capacity for and a focus on the following sets of issues.

Market Information

This is primarily about providing basic information about the market potential in a country or a sector to potential investors and would include, at the very least, an accurate assessment

of the potential returns on offer and potential risks. More specific details about particular investment opportunities and who to approach, and a step-by-step guide to investing would be even more useful for potential investors. This function will become even more important as DFIs move into more challenging economies.

DFIs need to leverage its their unique dataset and institutional memory to make a business case for investing in difficult markets, supported by their own data and through a good use of successful case studies.

Market Reputation

Even amongst large institutional investors, there is very little knowledge and understanding, for example, about African markets in particular. Some of this can be put down to lack of experience, but in general a negative perception of African markets being high risk and low return goes much beyond that and can be traced back partly to the persistent, mostly negative stories about African countries in the media.

Hans Rosling has aptly demonstrated the implicit biases and poor understanding of the current state of affairs that this brings about. Developing a Rosling-style myth-buster package can bolster the reputation of DFI markets, and help reduce information asymmetry about them and through that, the perceived risk premium. The asymmetry is biggest in fragile and conflict states of the kind that DFIs such as CDC will now focus on.

Market Development

This is about introducing new practices, new knowledge, new financial instruments and new standards to a market and a core part of DFI's model of change. Once a DFI has pioneered an investment, others can follow more easily and, particularly with the need for DFIs to direct more investments towards fragile and conflict states, this will become even more relevant.

This also includes building up much needed human capacity, for example, by seeding new private equity firms and having secondment and training programs to increase in-country investment expertise.

DFI policy engagement with OECD DAC donors, as well as with the host countries, would also be important, typically in fragile and conflict states, where private sector often faces the most challenging policy environment. The mobilization team, together with the policy and strategy team, has an important role to play there.

Market Demonstration

Within the business model of DFIs, the role of demonstration that a profitable private business can thrive even in a challenging and poor country is perhaps the most critical role they play. Here, a more proactive engagement with the media, with helping shape the narrative on private investment in frontier economies and a much more proactive and widespread use of successful case studies can a be very successful in mobilizing private capital and inspiring talented entrepreneurs in the long term. The mobilization team would have a central role in pulling together and disseminating such material.

Market Capital

This, of course, lies at the heart of the mobilizing function of DFIs. While it is always possible to attract as much private capital as one wants by offering generous loss protection, subsidies and yield-enhancement at the cost of taxpayers, that would defeat the purpose of the DFI model if done indiscriminately.

That is why, capital should preferably be mobilized on commercial terms, and have risk bearing capacity. Hence, our suggestion is for DFIs to have a waterfall or cascade approach to instruments, which prioritizes mobilizing risk-bearing capital first. In certain instances, where poor market conditions and potentially large development impacts justify it, it may make sense to offer public subsidy to attract private capital - but such subsidies should be temporary and used only with great caution.

DFIs might find themselves having to make increasingly difficult calls in its most difficult markets. While mobilizing commercial capital would be the core business of the mobilization team, but as discussed earlier in the report, it would need to also have dedicated outreach to impact and concessional investors.

Market Capacity

This is a complicated metric that captures everything from the overall environment for the private sector to market completeness in terms of supply-chains and eco-systems to precedents for deals, private equity, standards and instruments used, to human expertise in the form of entrepreneurs and investors. DFIs' influence in terms of developing market capacity works across the board. Here, the mobilizing team can play an important role in tracking market capacity over time.

Overall, DFIs must remember that mobilization is a multi-faceted phenomenon, so in order to be effective DFIs will need to build capacity across a number of dimensions such as investor relations, portfolio analytics, legal and regulatory issues, communications and outreach, and policy and advocacy.

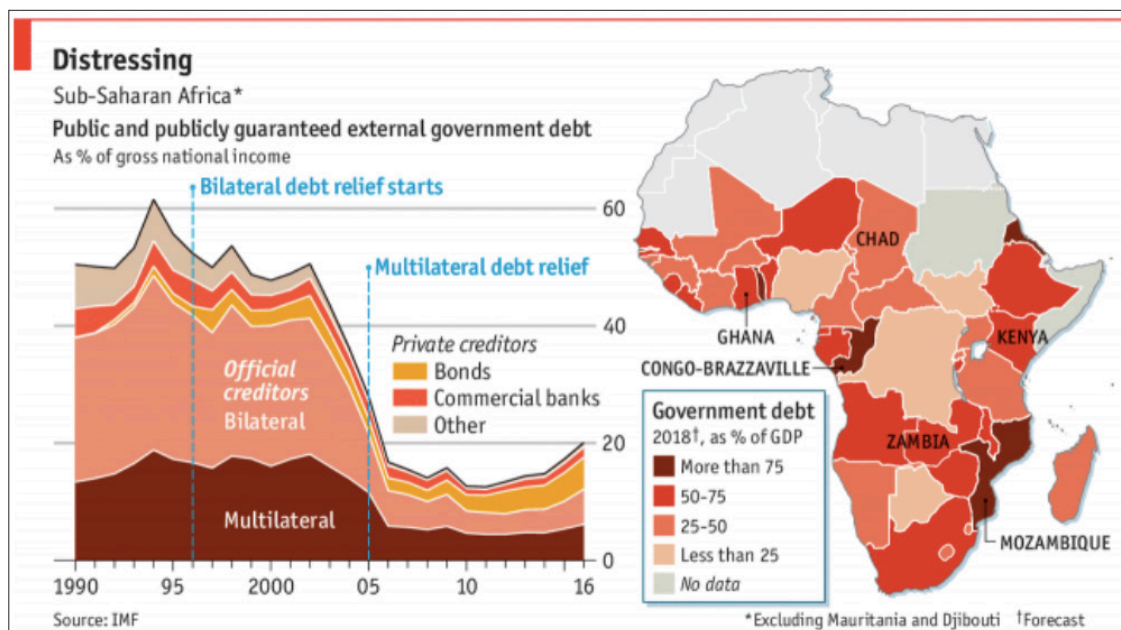
The matter of the trade-off between the quality and quantity of capital mobilized and the potential of blending to address the SDG funding gap and enable a scale-up of DFI mobilization potential is addressed in a forthcoming report for Norfund by Re-Define.

CHAPTER 7: DEALING WITH DEBT

The 1990s and early 2000s were dark days for developing country debt, particularly for the poorest economies in Africa and Latin America. Countries such as Ghana and Mozambique, with 120% and 200% of GDP in government debt, could not even cover interest payments due on this debt. The Economist sums up the situation that prevailed well: *“Two decades ago much of sub-Saharan Africa was frozen out of the global financial system. Reckless lenders had lent too much to feckless (and often unelected) governments. Crooked officials had stolen billions, stashed their loot abroad and left their fellow Africans with the bill.”*⁸⁰

A groundswell campaign, concerted advocacy and a belated recognition that much of this debt was unpayable finally led creditors, which were mostly rich OECD economies, multilateral development banks and the International Monetary Fund (IMF), to write-off large chunks of this debt. This was done through the Highly Indebted Poor Country (HIPC) program and the MDRI (Multilateral Debt Relief Initiative) which cancelled much of the outstanding debts owed by the poorest indebted countries.

This allowed most of these economies to recover and many have seen years of growth, rising health, social and education spending and significant poverty reduction. By 2012, the median debt burden in sub-Saharan Africa had fallen to 30% GDP. But as the following graph shows, it has begun to rise rapidly since, and is already over 50% of GDP and rising.



Source: *The Economist*⁸¹

While this does not appear very high by the standards of the eurocrisis, African economies raise only between half and a third of taxes that Eurozone economies do, so governments have much fewer resources to repay debts with. No wonder then that the IMF thinks that five African economies are already in debt distress, and that a further nine are likely to join them.⁸²

This time may be worse

What is worse, this time round it may be much harder to deal with debt distress. Owing the money to OECD countries, members of the Paris Club and majority shareholders of the World Bank and IMF made it easier to co-ordinate efforts and providing debt relief. This time round, the countries have been borrowing willy-nilly from commercial banks, institutional investors, companies and non-OECD lenders, particularly China. Interest rates on commercial loans and bonds are higher, and may rise further as monetary policy continues to tighten in OECD economies. To add to this, the terms of a large chunk of the borrowings, for example, loans from China, are not known.

Moreover, it does not seem that many of the lessons of the last debt crisis have been learnt. Debt is not bad. Borrowing, if put to good use, such as being deployed in the productive economy, cannot only generate development and growth but also be easily paid back. Not so if it is siphoned off illicitly, diverted for corrupt means or contracted on onerous terms. Ghana, Chad and Mozambique are all examples of where onerous terms or a corrupt diversion of funds have left the country carrying the can for repaying unaffordable debt with no benefits to show for⁸³. The past few decades have seen more than 60% of borrowing in Africa siphoned off. The concept of odious or illegitimate debt⁸⁴, introduced into the lexicon in the last crisis, comes to mind.

Even where the borrowing has not been so egregious, it has negative impacts. In Zambia, for example, debt servicing takes a bigger share of GDP than the education budget. Public borrowing is crowding out private enterprise, undermining the international community's focus on private sector led development. Mobilizing commercial capital for highly indebted economies becomes far harder and in the event of a default, the local banking system will have to be re-structured just as it was in Greece casting a further dark shadow on the economy.

A new debt trap looms over sub Saharan Africa, unless something is done urgently. In any event, at least some of the loans will have to be restructured so a focus on prevention alone is not enough.

What can be done

It is time to look at the expanded lessons from the debt crises of the last decade, as well as the lessons from the eurozone debt crisis. The toolkit and policy solutions available to the international community are vastly more expanded and can be put to good use.

First, the IMF should send a warning signal to borrowers and lenders about the impending debt problems.

Next, the World Bank should prioritize developing a market for GDP-linked and commodity linked bonds, not too different from the hundreds of billions of dollars of Co-Co securities, contingent capital, that has been issued by western banks.

Third, the Paris Club should sign an associate agreement with China that requires China to disclose the terms of its loans and binds it to renegotiation of its debt, if and when it becomes necessary.

Fourth, the World Bank, IMF and the UN should recognize the concepts of odious debt and illegitimate debt developed by United Nations Conference on Trade and Development (UNCTAD)⁸⁵, and Norway⁸⁶ respectively, and apply these in the restructuring and cancellation of debts already taken.

Fifth, the UN should adopt a statutory international debt workout mechanism as put forward by UNCTAD.⁸⁷

Sixth, as suggested by the IMF, all issuing economies should include strict binding collective action clauses in all bonds they issue.

Seventh, all countries should adopt the lessons from banking sector reform to apply them to sovereign debt issuance as laid out for the Eurozone.⁸⁸

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