THE VOICE OF BUSINESS AT THE OECD

Private Sector Perspectives on Private Financing for Sustainable Development

BIAC Discussion Paper

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1. Development finance: The current state-of-play

Sustainable development is at a critical juncture. On the one hand, the international development community is forging a bold new set of goals and targets, to be launched in 2015, that will shape the development of economies and societies for decades to come. However, unless urgent action is taken to generate the necessary financial means to make sustainable development a reality, global efforts will fall short of expectations.

Consider some of the most fundamental human needs to succeed in today's world, such as water and sanitation, food, energy, transport, health care, and communications: these needs can only be properly addressed through greater infrastructure investment in developing countries. Yet the estimated annual shortfall in global infrastructure debt and equity investment is at least USD 1 trillion.[1] For ASEAN countries, for example, around USD 8 trillion will be needed to bridge the gap in infrastructure financing by 2020.[2] In Sub-Saharan Africa, the cost of redressing the infrastructure deficit is estimated at USD 75 billion per year – the equivalent of approximately 12% of Africa's GDP.[3]

Bear in mind also that micro, small and medium-sized enterprises (MSMEs) participating in the formal economies of developing countries account for around 45% of employment and a third of their GDP; yet approximately 70% of formal and informal MSMEs do not use external financing from financial institutions, despite being in need of it, and a further 15% are underfinanced.[4] In 2010, the

[1] World Economic Forum (2014) "Infrastructure Investment Policy Blueprint", available online at: http://www3.weforum.org/docs/WEF_II_InfrastructureInvestmentPolicyBlueprint_Report_2014.pdf
[2] World Economic Forum (2014) "US$ 8 Trillion Needed to Bridge ASEAN's Infrastructure Gap", available online at: http://www.weforum.org/news/us-8-trillion-needed-bridge-asean-s-infrastructure-gap
[3] World Bank (2013) "Fact Sheet: Infrastructure in Sub-Saharan Africa", available online at: http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/AFRICAEXT/0,,contentMDK:21951811~pagePK:146736~piPK:146830~theSitePK:258644,00.html
[4] This figure would be much higher if MSMEs in informal economies were also considered. See: Stein, P., Goland, T., and Schiff, R. (2010) "Two trillion and counting: Assessing the credit gap for micro, small, and

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total estimated unmet need for credit by all formal and informal MSMEs in emerging and developing markets stood at USD 2.1 to 2.5 trillion – i.e. the equivalent of roughly 14% of total developing countries' GDP.[5] Lack of credit, while not the only obstacle facing MSMEs, is a major constraint to economic growth in many parts of the developing world.

In addition to shortfalls in infrastructure investment and credit for MSMEs, several other financing needs exist. For example, additional investment requirements for climate-related goals and targets are estimated to be of the order of several trillion dollars per year.[6] In addition, it is estimated that a global safety net to eradicate extreme poverty in all countries (measured as increasing incomes of the poorest to the USD 1.25 per day standard) would cost around USD 66 billion annually.[7]

Putting it simply, the enormous financing gap facing developing countries is a resounding wake-up call to policymakers around the world. International fora such as the *UN Intergovernmental Committee of Experts on Sustainable Development Financing,* the *G20 Development Working Group*, and the *OECD Development Assistance Committee (DAC),* must therefore play key roles in improving global understanding and consensus on how best to scale-up development finance.

While action is needed to increase public, private, domestic, and international development finance[8], all of which have important and complementary roles to play, particular focus has to be placed on mobilizing private finance. Sustainable development will only realize its full potential if the private sector is encouraged to contribute to the growth and financing needs of developing countries. This BIAC discussion paper therefore focuses on private sector financing for development.

Our four key recommendations to policymakers, detailed in the following pages, can be summarized as follows:

1. **Developing countries must prioritize the creation of attractive enabling environments, based on solid legal and institutional foundations, coupled with macro-economic and policy consistency.** This cannot be emphasized enough; it is imperative for reducing risks and stimulating domestic and international private investment.

2. **The international donor community should recognize that development finance should not compete with commercial finance; instead, it should fill the gap where the market fails to operate.** The DAC and development finance institutions (DFIs) should foster international agreement on this issue. Linked to this issue, the DAC should develop a commercial viability test for untied aid, while the eligibility of developing countries to receive ODA should consider whether they are able to access market-based finance.

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medium-sized enterprises in the developing world", McKinsey & Company and IFC article, available online at: http://www.mspartners.org/download/Twotrillion.pdf

[5] Ibid.

[6] UN Intergovernmental Committee of Experts on Sustainable Development Financing (2014) "Report of the Intergovernmental Committee of Experts on Sustainable Development Financing: Final Draft", available online at: http://sustainabledevelopment.un.org/content/documents/4588FINAL%20REPORT%20ICESDF.pdf

[7] Ibid.

[8] As defined by the UN Intergovernmental Committee of Experts on Sustainable Development Financing (2014).

3. **Donor countries should incentivize the use of credit guarantees.** This would give a much-needed boost to private sector confidence to invest in developing countries, notably in infrastructure. The DAC in particular should include credit guarantees in its definitions of ODA and/or total official support for development (TOSD).

4. **Greater coordination is required among donors, as well as between development finance institutions (DFIs) and export credit agencies (ECAs).** This could help to ensure more efficient and effective use of development finance.

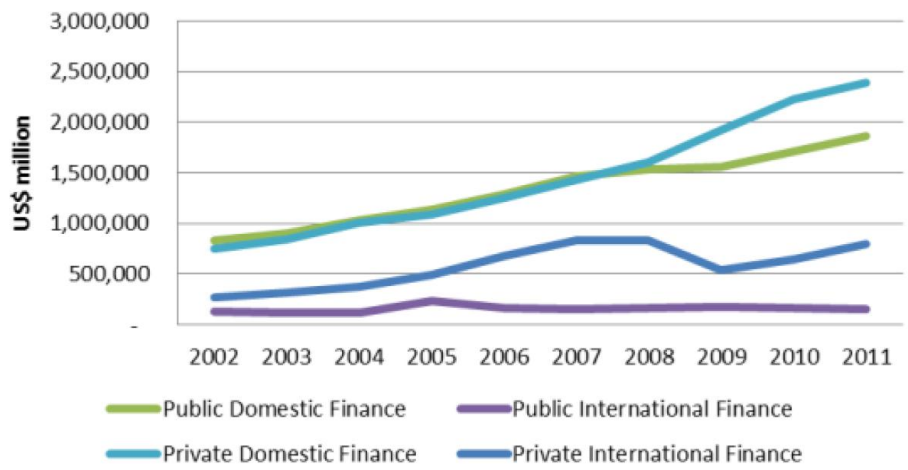
2. Why private finance matters in development

Private finance is central to development. Domestic private sector growth is the lifeblood to developing countries' economies, whereby businesses deliver investment, trade, jobs, and innovation. As shown in Chart 1, domestic private finance has greatly surpassed public finance in recent years, making it the single largest source of finance for all developing countries.

Similarly, international private finance – driven by trade and FDI – far outstrips international public finance (Chart 1). For least developed countries, the average trade-to-GDP ratio has risen from 38% in 1990 to 70% in 2011.[9] Meanwhile, gross flows of FDI to developing countries reached USD 778 billion in 2013, surpassing FDI to developed countries.[10]

Chart 1: Development finance, all developing countries

Source: UN Intergovernmental Committee of Experts on Sustainable Development Financing, 2014.



Nevertheless, the volume of financing to developing countries is still not sufficient to meet developing countries' needs, as highlighted in section 1 of this paper. Nowhere else is this more evident than in the least developed countries: Chart 2 reveals that both domestic and international private finance, as

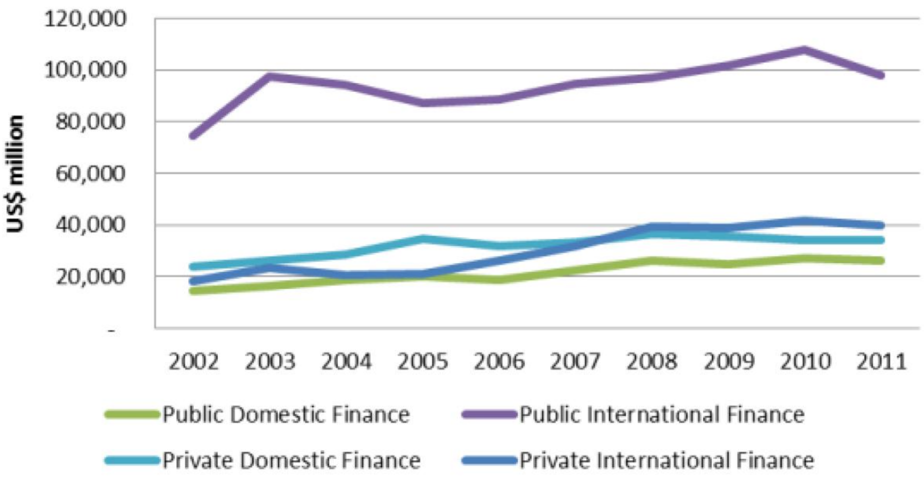
[9] UN Intergovernmental Committee of Experts on Sustainable Development Financing (2014) "Report of the Intergovernmental Committee of Experts on Sustainable Development Financing: Final Draft", available online at: http://sustainabledevelopment.un.org/content/documents/4588FINAL%20REPORT%20ICESDF.pdf

[10] Ibid.

well as domestic public finance, are not nearly enough to put these countries onto a sustainable growth path; instead, they are heavily dependent on public international finance (e.g. ODA).

Chart 2: Development finance in least developed countries

Source: UN Intergovernmental Committee of Experts on Sustainable Development Financing, 2014.



In summary, raising the levels of private finance in all developing countries must become a top priority if sustainable development objectives are to be achieved, particularly in the case of least developed countries. The recommendations described in the following pages all concentrate on this goal. Urgent actions are needed to reduce risk, avoid crowding-out private investment, and to use development finance more efficiently and effectively.

3. Recommendations

I. Strengthen enabling environments

Improving the domestic policy, legal, regulatory, institutional and macroeconomic environment – key aspects of an enabling business environment – is not only good for business, but also for sustainable development. Rule of law and effective institutions are the bedrock of our economies and societies, without which sustainable development would be impossible. Additionally, economic growth depends on policy consistency and overall macroeconomic stability, which are key conditions for entrepreneurship and market confidence to trade and invest.

Putting oneself into the mindset of a private sector company, one quickly recognizes the importance of these conditions – not just for enabling the growth of the company, but also more fundamentally for the company’s survival. Burdensome regulatory barriers, regulatory instability, lack of rule of law, corruption, and extreme macroeconomic volatility are just some of the factors all-too-common in developing countries that can easily cripple companies and the benefits that they deliver to economies and societies.

The enabling environment is equally concerning to institutional investors, whose financing many developing countries are increasingly eager to attract. It should not be forgotten that lack of long-term political commitment, inadequate project pipelines, regulatory instability and/or fragmentation, regulatory barriers, unnecessarily high capital charges, and lack of transparency, drive away long-term investors.

While the building of enabling environments has been recognized by the international development community many times in recent years[11], the serious task of implementing the necessary policy reforms must not be sidelined in global discussions. For example, the UN Open Working Group on Sustainable Development Goals – a core part of the Post-2015 development agenda – appears to diminish the importance of economic growth and an enabling environment by burying goals related to these objectives late in its Outcome Document (Goals 8 and 16). This is concerning for the business community which seeks firm commitment to reforms that will foster growth and competitiveness.

There is no escaping the fact that developing countries need to redouble their efforts to improve the fundamental policy, regulatory, institutional, and economic conditions for growth and development. This has to be the centerpiece for the Post-2015 development agenda. Towards this objective, the OECD, in its discussions with developing countries and the international donor community, should be unrelenting in making the case for structural reforms.

II. Make public development finance complementary to private finance

Public development finance should not crowd-out private finance; instead, it should fill the gap in countries or sectors where the market cannot yet deliver. Two specific recommendations should be considered, as follows:

Firstly, donors in the OECD Development Assistance Committee (DAC) should be informed about what the private market is currently able (and unable) to finance in a given country.[12] This would allow donors to determine where and how to best allocate ODA. Currently, however, the ODA eligibility of countries is based solely on the assessment of their respective GNI per capita, but is not based on their access to commercial markets; this means that some countries continue to receive ODA despite being able to raise finance through markets. Moreover, the fact that some countries receiving ODA

[11] See for example paragraph 32 of the Busan Partnership Document of the Fourth High-Level Forum on Aid Effectiveness, held in Busan in 2011, available online at: http://effectivecooperation.org/files/OUTCOME_DOCUMENT_-_FINAL_EN2.pdf . See also the Joint Declaration on Expanding and Enhancing Public Private Cooperation (2011), available online at http://effectivecooperation.org/wordpress/wp-content/uploads/2014/04/JointDeclarationonexpandingandenhancingpublicprivatecooperation.pdf

[12] For example, the OECD Export Credits Country Risk Classification could be used as a proxy for countries' access to private markets. If a country is classified in category 7 (the highest risk category), most OECD Export Credit Agencies would not cover medium to long-term risks in these countries, implying that these countries have no or limited access to commercial finance. These countries should therefore be clearly eligible for ODA and other forms of subsidized development finance. Conversely, countries with an OECD categorization of 3 or better may be considered more able to raise private financing and less dependent on ODA, and thus more ODA could be devoted to other countries most in need.

also provide aid to other countries illustrates that the dependence on the GNI per capita measure is outdated and leads to inefficiencies.

Secondly, a commercial viability test should be developed and implemented for untied development aid in order to increase aid efficiency and avoid crowding out private finance. Donors of tied aid are already urged to carry out such a test, asking themselves whether a specific project is financially viable and whether market-based finance will be sufficiently available to finance it. Donors of *un*tied aid should be encouraged by the OECD DAC to implement a similar commercial viability test, recognizing that projects which generate sufficient cash flow can be financed on market terms should not require aid in the form of concessional loans and other subsidized loans.

III. Incentivize the use of credit guarantees

Credit guarantees are perhaps the most effective instrument for catalyzing private finance and therefore merit far greater political attention and support.

Guarantees give developing countries access to other sources of finance on better terms than those available on the market (such as longer credit periods and more favorable interest rates and lending conditions), and make tailor-made risk-sharing between commercial financiers and development financiers possible. They serve to increase substantial amounts of commercial finance from both public (e.g. export credit agencies) and private sources.

However, guarantees are not currently included in the definition of ODA. Instead, they are only counted as ODA in cases when a guarantee is claimed, i.e. where an investment defaults and the compensation paid is reported as ODA.[13] Moreover, guarantees are often issued without any explicit development purpose (instead, only commercial purpose), despite the fact that they can generate major development impacts.[14] So long as guarantees cannot be reported as ODA, and so long as focus is only on guarantees with development purpose, donors may therefore have less incentive to use these instruments in their development activities.

The OECD DAC should explicitly recognize credit guarantees in its process of modernizing the definition of ODA, and the supplementary measure of total official support for development (TOSD). In doing so, the DAC definitions should capture credit guarantees which have development *impact*, and not solely those with development purpose.

[13] Defaults in sustainable credit guarantee schemes are kept low. The OECD reports that a sustainable credit guarantee scheme should aim to have a default rate of no more than 2 to 3 percent, while newly established schemes might consider a higher default rate (e.g. over 5 percent) in early years of operation. See OECD (2010) "Facilitating Access to Finance: Discussion Paper on Credit Guarantee Schemes", OECD Publishing, Paris.
[14] Export credit guarantees are an example of a commercially-motivated guarantee which has an important development impact.

IV. Foster greater coordination among donors, development finance institutions (DFIs), and export credit agencies (ECAs)

Inadequate coordination among different actors in the global development community leads to inefficiencies in development finance, impairing its potential to mobilize private financing.

For instance, the management of different donor procedures can be highly burdensome for recipient countries, overloading their administrative capacities and leading to inefficient allocation of resources.[15] While OECD DAC members have been working towards greater harmonization, there is still a significant shortcoming in the DAC's coordination with a number of non-OECD donors. Some of these non-OECD donor countries are not bound by OECD Export Credit Agreements and/or OECD DAC commitments, nor IMF and World Bank Debt Sustainability Standards, meaning that these countries can easily blend public development finance and official export credits in ways that OECD DAC members cannot. The result is a fragmented donor community in which businesses of some countries unfairly benefit, businesses of DAC members lose out, recipient countries continue to face inconsistent donor practices, and the potential for raising overall private finance is weakened. The DAC must continue to strengthen cooperation with non-DAC donor countries in order to promote greater international coordination and more efficient global markets.

Similarly, there needs to be greater coordination between ECAs and DFIs. While export credit guarantees have commercial purpose, they often generate development impact. By scaling-up the use of export credits and guarantees, substantial amounts of public development finance could be freed up and used for other important development purposes. A regular dialogue should be encouraged between representatives of the OECD DAC and the OECD Export Credits Working Group to explore possible strategies for enhanced cooperation.

4. Conclusions

The need to catalyze more private financing in developing countries is well-recognized; now the global development community must forge consensus and understanding on the instruments and rules to make it happen. The four key recommendations set out in this BIAC paper are all pointed towards this objective, and they will require the building of dialogues that stretch beyond the traditional donor community to the worlds of commercial financing and economic policy. The OECD, in its multidisciplinary scope, is uniquely well-placed to take the lead on this matter and contribute actively to the Post-2015 development agenda.

[15] OECD (2003) "Harmonising Donor Practices for Effective Aid Delivery: A DAC Reference Document", DAC Guidelines and Reference Series, OECD Publishing, Paris.