Development Policy Forum

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UNLOCKING PRIVATE SECTOR INVESTMENT IN FRAGILE STATES

POLICY INSIGHT

REPORT

INTRODUCTION:
HOW TO BRING INVESTMENT TO WHERE IT'S MOST NEEDED

Private investment is essential for the development of fragile states, but in order to attract foreign investors and encourage domestic one, governments must work to create the right environment. That was one of the main messages from two Friends of Europe events on 31 January, when experts discussed how best to attract investments and the private sector into difficult environments.

Private-sector finance is considered essential for meeting the Sustainable Development Goals adopted in 2015 by the United Nations General Assembly. This "Agenda 2030" calls for the promotion of development in a way that protects the environment and respects human rights, and their scale means they will need trillions of euros in financing. Governments cannot provide these amounts through official development assistance (ODA). Moreover, to grow beyond aid dependency, fragile states need a strong private sector to provide goods and services, generate tax revenues and create employment.

However, fragile states often suffer from damaged infrastructure, weakened institutions, an inadequate regulatory framework and political uncertainty. In the poorest countries, much of the population lacks access to clean water and primary education. These challenges mean that only 6 percent of the foreign direct investment that went to developing countries in 2012 went to countries on the fragile states list.

Mobilising the private sector in conflict-ridden countries or so-called frontier markets must therefore be a key priority. The Policy Insight **'Unlocking private sector investment in fragile states'** explored ways to do this. The event was organised in partnership with the International Finance Corporation (IFC) on the occasion of its 60th anniversary.

However, marrying aid and private investment sounds like a tricky balancing act, as the private sector needs to turn a profit. Fortunately, businesses are increasingly aware that only sustainable economic activities will be profitable in the long term, a theme taken up in the dinner debate, **'Innovative financing tools for development – From theory to practice'**.

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Nena Stoiljkovic
Vice President for Blended Finance and Partnerships at the International Finance Corporation (IFC)

INVOLVING THE PRIVATE SECTOR

Large-scale private sector involvement marks a departure from the traditional reliance on ODA. But the role of governments and government institutions will be crucial. First, they must identify the kind of private sector activity likely to contribute most effectively to key sectors in developing countries. Then they have to help reduce factors that often discourage the private sector from investing. That can mean promoting the rule of law, helping to build complementary infrastructure and addressing key constraints for the private sector to invest.

"The private sector is risk averse," said moderator **Shada Islam**, Director for Europe and Geopolitics at Friends of Europe. "It sounds very good in theory – but in practice?"

"Trillions of dollars are needed to finance the implementation of the SDGs by 2030," said **Nena Stoiljkovic**, Vice President for Blended Finance and Partnerships at the International Finance Corporation (IFC), the private sector arm of the World Bank Group supporting private sector clients with investments and advisory services. "The private sector will have to be the source of those trillions of dollars in investment given limited ODA. To bring the private sector into more difficult markets, especially fragile and conflict-affected states, we will need to de-risk their investments and work with governments on sector reforms."

In its early years, the IFC introduced western companies to emerging markets. Its first investment was a loan to help Siemens manufacture electrical equipment in Brazil. Later, IFC looked for local sponsors and companies in emerging markets, helping them structure their investments, and offering a range of advisory services to build their capacity, improve standards and expand their partnerships with others. To do so, IFC had to decentralise and now has offices in more than 100 countries with sixty percent of staff based outside of Washington, DC.

The IFC is now adopting a new approach, working proactively to create markets. In the past, the IFC waited for a project to become available for financing, and then sought ways to structure and strengthen it. Now, it gets involved further upstream. "We're really going into those countries early on and helping create the market," she said. "We will work very closely with the World Bank on this given its focus on policy and sector reforms. We will use private sector diagnostics to identify which sectors have the highest potential for private sector involvement. Then we will identify private sector clients, whether they are foreign, local or regional, who would be interested in coming into those sectors. All of this implies a more proactive engagement up-front and with clients, leveraging available de-risking and advisory instruments in addition to much closer collaboration with the World Bank."

A big reason for the new approach is that the economics of some of the key sectors often limits private sector engagement. For example, in the energy sector, before work can start on setting up a power supply through private investments, sector reforms are often needed, and the right regulatory framework has to be in place. “Then, we can use blended finance and guarantees to de-risk those projects,” said Stoiljkovic. In Côte d’Ivoire, for example, IFC arranged a $345 million package to modernise the Azito Thermal Power Plant, which will enable it to generate 50 percent more energy from the same amount of gas. IFC provided $125 million, and arranged for six other development finance institutions to put up the balance. The World Bank provided advice to the government on the regulatory framework for power and MIGA provided political insurance to de-risk the project.”

The urgency of bringing investment to developing countries can be seen by having a look at the demographics in many poorer countries. In some, 60 to 70 percent of the population is made up of youth, said **Viwanou Gnassounou**, Assistant Secretary General for Sustainable Economic Development & Trade at the African, Caribbean and Pacific Group of States (ACP) Secretariat. The African Development Bank says there are 80 million unemployed youth on the continent. “Every year we have another 12 to 15 million come into the market, and we are able to create only a maximum of 5 million jobs,” said Gnassounou. “So, every year we have about 10 million more unemployed youth. Where are we going to find the jobs for them? If you don’t do that, you can forget all about the SDGs.”

Much of the focus for attracting investment is on big business. But activities such as farming might have more potential to generate employment. The trouble is, the field has a poor reputation among young people. “If you look at the cocoa or coconut sectors, the average age of the farmers is over 60,” said Gnassounou. “No youth is interested in going into agriculture, even though it creates the wealth of these countries.”

For young people to want to work in agriculture, they need to see the opportunities there. So, the ACP is promoting relatively small farming projects, usually between 50,000 and 200,000 euros. “Those are not in the range of the IFC or for private equity,” said Gnassounou. “We are bringing some expertise to try to link small family farmers to global and regional value chains.”

Another challenge is to persuade African commercial banks that agriculture is a good bet. Many think it’s too risky – largely because they don’t know the business, according to Gnassounou. “What we do with the public money is not only to train the farmers and cooperatives to develop better projects, but also to train the financial institutions to understand the business.”

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Harald Hirschhofer
Senior Adviser at the Currency Exchange Fund (TCX)

NEW FINANCIAL TOOLS

Investing in developing countries brings other risks, such as exchange rates. If a local currency falls, then so does the value of an investment in that currency. The Currency Exchange Fund (TCX) helps investors hedge against currency risk. In the 10 years since it was formed, TCX has hedged about $4.5bn of currency risk, mainly in microfinance and for SMEs. The average loan size is between $200 and $300. "We say: If you want to invest in fragile states, don't look only at the individual business, look at the macro risks," said **Harald Hirschhofer**, TCX Senior Adviser. "Managers cannot influence these, so these are sometimes the main barrier."

In the 11 most fragile states it operates in, TCX has done $350mn of transactions over the past few years. However, said Hirschhofer, "These risks are so high that a private sector project simply cannot pay for the insurance if it is priced in a sustainable way. That's the challenge we need to overcome."

Often the financing goes through several parties. For example, Kenya-based solar home systems provider M-KOPA has connected nearly 500,000 homes in Kenya, Tanzania and Uganda to solar power since 2011, and is adding over 500 every day. A large part of its financing comes from an asset manager called responsAbility Investments AG. To hedge its local-currency loans against exchange rate fluctuations, responsAbility uses a specialist provider of currency hedging products called MFX. In turn, MFX often hedges risks with TCX, which is backed by the German and Dutch governments.

"There were three innovations," said Hirschhofer. "First, solar panels, which make it now viable to produce decentralised energy. Second, micro-credit with good control over the repayment patterns, which means very low default rates. The third innovation was TCX: We could hedge these currencies where nobody else had done so before. If you want to go from billions to trillions, you need to have high efficiency in the utilisation of capital."

DEVELOPMENT NEEDS TO RESPECT PRINCIPLES

Involving the private sector changes the role of the EU and the ODA it provides. In particular, the European Development Finance Institutions – an association of bilateral institutions that work to develop and reform economies – need to start playing a larger role, said **Roberto Ridolfi**, Director for Sustainable Growth and Development at the European Commission Directorate General for International Cooperation and Development. "We now talk about

actors more than instruments or projects," he said. "We have to eliminate the word 'project' from our vocabulary. We have to eliminate the word 'programme'. Instead, we have to use the word 'investment'."

However, the EU is still concerned with the political state of countries where it promotes investment, for example through the new European External Investment Plan (EIP) to encourage investment in Africa and the EU neighbourhood region. "The first point of policy is that the jobs the EIP is meant to create – or maintain, if at risk – will be decent and sustainable jobs," said Ridolfi. "That is a message that concerns the policy mandate that the Commission is fulfilling in DEVCO and NEAR", the Directorates-General for International Cooperation and Development and for European Neighbourhood Policy and Enlargement Negotiations. Investments must respect the EU's principles. "A financially rewarding investment may arise in a country where there are problems in terms of human rights, rule of law or democracy," said Ridolfi. "As the EU, we have a reputation to protect. Is that a matter for discussion? I think it is."

One important principle is additionality: what extra investment public money will trigger, and the quality of the operation that results. If an investment will happen anyway, there is no need for public-sector assistance. "If my intervention as a public actor doesn't create additional volume and investments, then I'm wrong; I'm doing something that I shouldn't do," said Ridolfi. "That additionality is not only in terms of money. Perhaps it's in terms of more-decent, sustainable jobs. We are mandated to do this by the taxpayers through the EU's development policy."

There are other possible approaches to improving the quality of investments promoted through public funds. Some investment vehicles finance only businesses that do not exacerbate climate change, and a similar principle could be used for biodiversity – for example by guiding financing towards investments that support agriculture that uses less fertilizer and smaller quantities of chemicals.

"Do you remember? Twenty-five or thirty years ago, renewable energy was nowhere," said Ridolfi. "Then the index started appearing, giving a premium to those companies investing with renewable energy. Now let's do the same with biodiversity. If we manage to take biodiversity into the main financial markets as an index of sustainability, we make companies that promote biodiversity attractive for investors."

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THE NEW ROLE FOR ODA

Though its role is changing, ODA will remain essential. First, it represents a minimum commitment by rich countries to improving conditions in the developing world. Even if EU Member States never actually fulfil their commitment of providing 0.7 percent of GDP in ODA, at least it provides a target, said **Stefano Manservisi**, European Commission Director General for International Cooperation and Development. "ODA is the backbone – the oldest and most traditional way to fund development, and it is still seen as a key pillar because it shows a certain level of predictability," he said. Moreover, it acts as a signal to developing countries and to businesses that rich-world governments are working to improve the business environment. "It is also a way to measure the commitment of public government to do business."

Different types of funding are not in competition, Manservisi emphasised. Though the private sector expects, eventually, to obtain a profit from its investment, both the private sector and public aid need to boost development and create jobs. Still, when ODA is linked to private investment, it will insist on certain conditions. These will not be expressed as moral lectures, but as reminders of the need to stick to the concept of sustainability as expressed through the SDGs.

"Aid and profit are not antagonists any more," Manservisi said. "I don't remind you of your moral duties. I simply remind you that you are part of the environment of the UN 2030 Agenda for Sustainable Development, and that if you don't do things in a certain way, it will not be sustainable – meaning not only unsustainable in terms of development, but also in terms of the profit you hope to make. That means the mix with the right policies is particularly important."

CONCLUSION

The developing world needs private investment to create jobs for its burgeoning young populations, and in order to meet the demands of the SDGs. New approaches to financing – ranging from work on the regulatory environment to hedging currency risk – can help this. However, ODA remains an important lever. Governments can use ODA to attract private investment and also to ensure conformity with the SDGs.

“Aid and profit are not antagonists any more.”

Stefano Manservisi
European Commission Director General
for International Cooperation
and Development.

Friends of Europe

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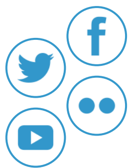

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