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Discussion Paper

MOBILIZING PRIVATE FINANCE *for* SUSTAINABLE DEVELOPMENT

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Discussion Paper

Mobilizing Private Finance for Sustainable Development

Abstract

The proactive engagement of the private sector was critical to accelerate the achievement of the Millennium Development Goals (MDGs). Inevitably, private finance will become even more central in the concerted effort to achieve the Sustainable Development Goals (SDGs) due to their ambition. Private investment decisions—in both the real economy and in the financial sector—should move the world towards the aspirations set out in the 2030 agenda. This means going far beyond philanthropy and voluntary corporate social responsibility, important though they are. It is a matter of steering the investment decisions that private actors make every day. In the context of the Financing for Development debate, this discussion paper reflects on the latest trends and makes recommendations to: 1. Establish an enabling regulatory environment for the private sector to invest in the SDGs; 2. Introduce "Smart" public incentives to fasten the realignment of private finance to the SDGs; and 3. Foster change in company and consumer behaviours to transition to inclusive and sustainable markets.

Financing Solutions for Sustainable Development (online platform)

For more information on possible financing solutions the private sector might adopt to advance sustainable development, visit our online repository of financing solutions that describes their potential, advantages, disadvantages, risks and characteristics. It profiles case studies and refers to multiple external sources, including e-learning and advanced guidance material, where available.

See: **www.undp.org/content/sdfinance.**

MOBILIZING PRIVATE FINANCE

Proactive engagement of the private sector was critical to the achievement of the Millennium Development Goals (MDGs). UNDP considers that the role of the private sector and private finance will become even more central in the concerted effort to achieve the Sustainable Development Goals (SDGs). Our organization works with companies—big or small—from a variety of sectors—water, energy, extractives, risk reduction, finance—to find common solutions to development challenges—from climate change adaptation to the response to Ebola—to facilitate public-private partnerships and to support on the ground the advent of an inclusive and vibrant private sector.

1. PRIVATE FINANCE IS NEEDED FOR SUSTAINABLE DEVELOPMENT

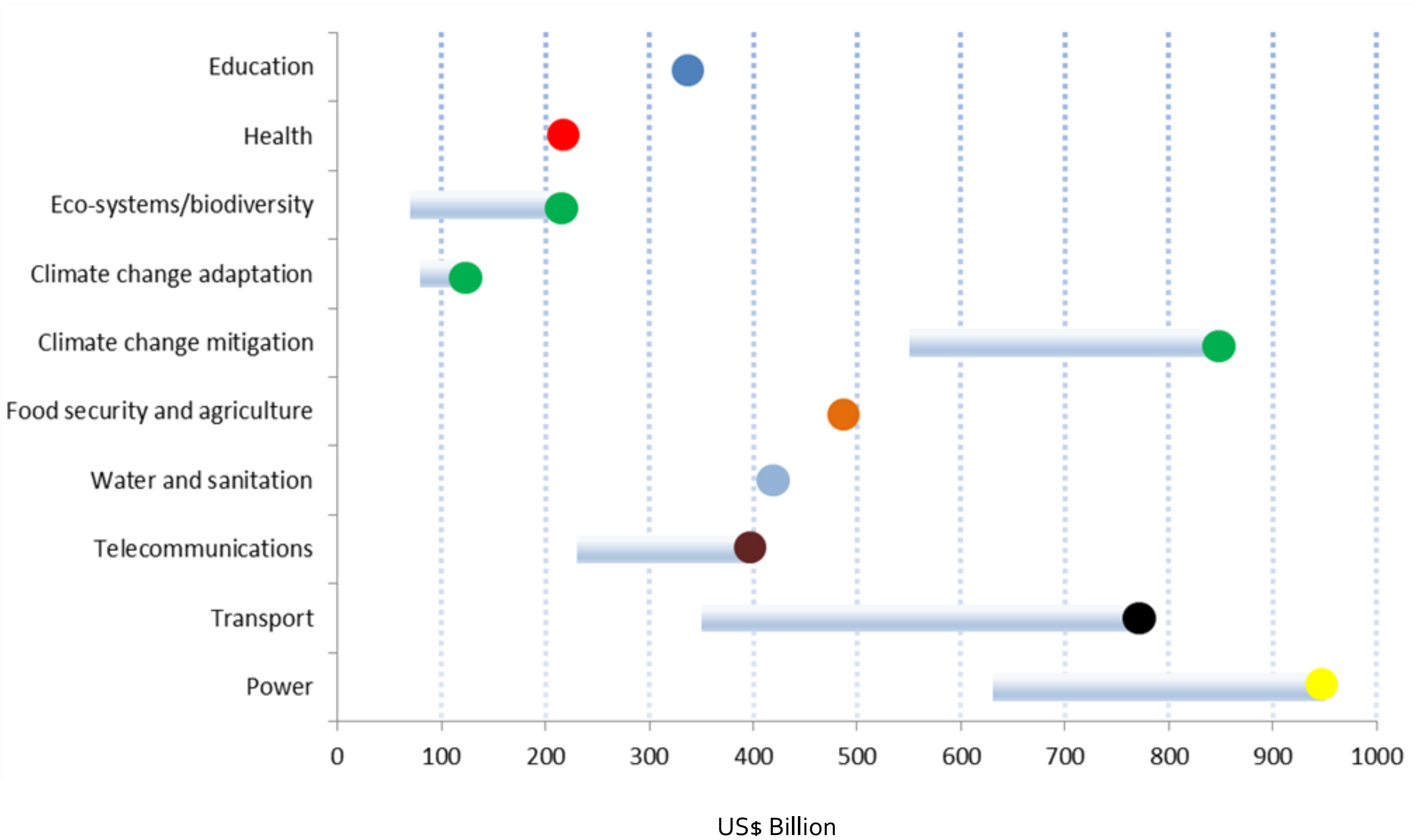
Inevitably, the largest share of resources to fund the sustainable development agenda will come from the private sector. Given that the SDGs cannot be achieved through public finance alone, whether from domestic resources or Official Development Assistance (ODA), the challenge for governments will be to implement policies which serve to align larger amounts of these flows, from both public and private sector sources, with sustainable development aims. The challenge for the private sector is to move towards inclusive and sustainable business models without undermining profitability.

In the context of the Financing for Development debate, this paper reflects on the potential contribution of private finance—any financial means that could be made available by private individuals and corporations be it profit-making investments or donations to sustainable development. The 2030 agenda has been framed to tackle universal problems, from improvements in education and health, gender equality, to the fight against youth unemployment and the preservation of biodiversity, and attention is now focused on the means of implementation. This goes beyond identification of the sources of finance and encompasses broader issues such as policy choices at the national level and policy coherence at the regional and global levels, including on trade, tax and climate change. Policy trade-offs, capacities and technology are all important aspects of the current debate.

Developing countries will need support from the international community. UNCTAD estimates the midpoint of investment needs in developing countries at US$3.9 trillion a year, with an annual investment gap of US$2.5 trillion in sectors spanning education, health, biodiversity, climate change, food security and agriculture, water and sanitation, telecommunications, transport and power. These numbers point to the dimension of the challenge and dwarf levels of ODA, estimated only at US$168 billion in 2013.

What is then the rationale for investing private resources in sustainable development? What is the business case for private sector engagement? What safeguards need to be put in place? We explore some of these issues. The next section will look at the sources, quality and direction of private finance. Section 3 will suggest an approach to align private finance with the SDGs and some recommendations will be featured in the conclusion.

Figure 1: Estimates of investment required in SDG sectors in developing countries, 2015-2030 (US$ billion)



Source: Author's calculations based on UNCTAD, *World Investment Report 2014*: *Investing in the SDGs: An Action Plan* (Geneva, 2014). Available from: http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf.

2. THE SOURCES, QUALITY AND DIRECTION OF PRIVATE FINANCE MATTER

Private financial flows to middle-income countries grew steadily over the past decade. Some low-income countries also attracted an increasingly diverse mix of flows, including from South-South partners and private aid providers. The emergence of new markets across all regions was driven by a rising middle class, technology innovations, trade and investment liberalization and the "search for yield", in the context of prolonged low interest rates. These external flows have been outmatched in some instances by the growth of domestic investment, particularly in large middle-income markets.

There is no shortage of (private) capital across the world.

There is a relative abundance of liquidity across the world. Global wealth (i.e. the accumulation of national savings over time) grew continually after the crisis, surpassing US$250 trillion in 2014.[1] Between 2000 and 2010, domestic and foreign investments in developing countries quadrupled from US$1.6 trillion, to US$6.9 trillion, and, according to estimates, they could double again within the current decade. Outflows of resources from developing countries, both in the form of outward investment and repatriation of profits, also increased—to an estimated US$0.7 trillion in 2012.[2] Volatility has also been amplified following the deeper integration of developing countries into the global economic system.

[1] Credit Suisse, Global Wealth Report 2014 (2014). Available from: http://publications.credit-suisse.com/.

[2] This sum excludes illicit financial flows (see Development Initiatives, 2015, Available from: http://devinit.org/#!/).

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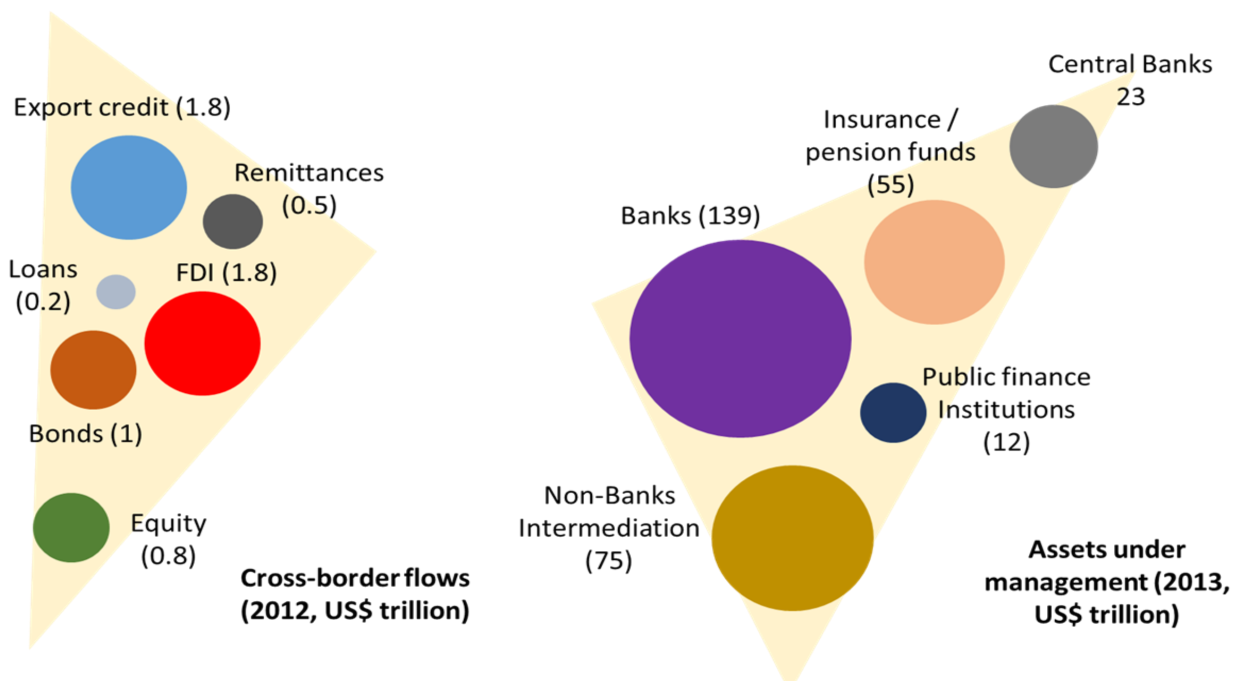
National savings remain at the origin of wealth accumulation. Saving rates vary widely as a share of GDP depending on geographical and cultural factors, the rate of economic growth, financial deepening and the population pyramid. Before the nineties the savings rates in developing countries were lower than those in developed ones. This pattern changed in the nineties when high domestic savings in East Asian economies and oil-exporting countries in the Middle East brought developing countries' domestic savings rate (32 per cent in 2009) to a level double that of developed countries.

This accumulated wealth is still managed mostly by banks and non-banking financial intermediaries housed in developed countries and a few financial hubs in East Asia. Of the US$68.3 trillion in assets under management by the world's top 500 asset management firms, the share of Asia—the largest emerging region—was only 9.7 per cent in 2012, of which about 92.5 per cent was managed by firms from Japan, Australia and South Korea.[3]

The distribution of wealth endowments reinforces the case for cross border flows. Figure 2 provides a snapshot of flows and assets held by the private sector. If insurance companies and pension funds are added, assets under management rise to an estimated US$270 trillion while cross border flows are will be close to US$9 trillion worldwide. Notably, the landscape is changing, with remittances quadrupling from 2000 and expected to surpass US$500 billion by 2016.[4] Excluding China, the volume of remittances is already higher than Foreign Direct Investment (FDI) in developing countries. Crowdfunding could become a disruptive force, with an estimated US$93 billion market by 2025.[5] Cross-border private aid (e.g. foundations, corporations, etc.) is estimated at US$60-70 billion per year, while national philanthropy movements are growing rapidly in developing countries.[6]

Figure 2: The landscape of private sector finance (flows and assets)



Note: export credit refers to new guarantee issuances.
Source: Author's calculations based on data from the Financial Stability Board, McKinsey and the Berne Union.

[3] Rao, Vivek, Developing the Financial Sector and Expanding Market Instruments to Support a Post-2015 Development Agenda in Asia and the Pacific, ADB Sustainable Development Working Paper Series No.36. (2015). Available from: www.adb.org/sites/default/files/publication/155081/sdwp-036.pdf.

[4] World Bank, Migration and Development Brief 25, Migration and Remittances, Recent Developments and Outlook, World Bank (2015). Available from: http://pubdocs.worldbank.org/en/102761445353157305/MigrationandDevelopmentBrief25.pdf.

[5] World Bank, Crowdfunding's Potential for the Developing World (2013). Available from: www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf.

[6] UNDP, Philanthropy as an Emerging Contributor to Development Cooperation (2014). Available from: www.undp.org/content/dam/undp/documents/partners/civil_society/UNDP-CSO-philanthropy.pdf.

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The quality and typology of financial flows matter. In the quest to mobilize resources for development, it is not enough to focus only on the financial instruments that can raise more funds. Understanding where the investment gaps are, what the projects' capital requirements are and the business case that will allow profitable private sector engagement are crucial. Firms in developing countries, for example, need better instruments to (affordably) access private finance. The demand from Micro, Small, and Medium Enterprises (MSMEs) for early seed finance instruments is strong but unmet as only a few institutional and private investors are able to serve such a clientele with adequate products.

A move away from a focus on short-term capital returns to a greater emphasis on long-term profitability is also necessary.[7] Moreover, the shorter-term objectives of financial investors imply that many of the prevailing investment strategies are not well-suited to sustainable development. Given that banks, non-banking intermediation and institutional investors are managing the largest share of world resources, a debate on how to better balance the demand from developing countries with the supply is necessary. Reorienting a small share of the assets held by pension funds, insurance companies and large foundations' endowments—the latter in the USA alone is valued at US$670 billion[8]—can help transform long-term finance in developing countries, as their investment objectives tend to be longer term. Pension funds in the North and the South can help address this gap, but they are held—justifiably—to provisions that limit their freedom to invest in riskier asset classes. Thus safeguards need to be put in place to reduce the financial risk profile of certain operations, particularly in infrastructure, to better match saving with investment opportunities.

Securing the mobilization and the prudent intermediation of private savings (including remittances) in developing countries will expand the frontier of available resources and will help to consolidate the financial sector in many developing countries where it still remains relatively small and undiversified. To this end, the establishment of investment vehicles, financial intermediaries and stock markets could be supported along with the capacity of market regulators. The emergence of project financing and venture capital in Africa should also be better studied to appreciate what needs to be done in frontier markets.

The direction of private finance is skewed to certain countries and sectors.

For the first time global companies are investing more in emerging markets than in the USA, Europe and Japan.[9] A number of African economies, where development needs are the highest, are now considered among the fastest growing economies in the world. Any company with global ambition will have to invest in developing markets. Yet, private sector investment continues to be highly concentrated geographically and sectorally, mostly in resource-rich countries, extractive industries and capital regions.

Policymakers, development partners and investors interested in a larger role for private finance in development must recognize that it still predominantly flows towards higher and middle income countries and to bigger firms. UNCTAD estimates that only 1.9 per cent of global FDI reaches the Least Developed Countries (LDCs). In Africa, the resource-rich countries' share of total FDI—even if in decline—is estimated at 70 per cent.[10] The IFC's estimate is that only 15 per cent of MSMEs in the world have access to appropriate credit and other financial services.[11] There is no indication this pattern will change without regulatory reforms that can shift incentives for investors combined with