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Sustainable development finance: Mobilisation of private capital

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In the 2015 summit year, and in particular with regard to the Third International Conference on Financing for Development in Addis Ababa, the topic of mobilising private capital is increasingly becoming a focal point of developmental and climate policy discussions. According to UNCTAD, there is a financial shortfall amounting to USD 2.5 trillion a year with regard to the Sustainable Development Goals (SDGs). In the last two years, ODA funds generated amounted to approximately USD 135 billion per year (about 0.3% of GDP of the donor countries). Even if the target ratio of 0.7% is achieved in all donor countries, this alone is not enough to close the financing gap for achieving the SDGs. However, public funds can be used to mobilise additional private investment.

Two levels of capital mobilisation

The mobilisation of private capital through ODA takes place mainly on two levels:

1) Direct mobilisation of private investors for development policy projects

The objective of this approach is to integrate private, mostly foreign investors in sound developmental projects. These include, among others, institutional investors such as pension funds and insurance companies as well as banks operated by churches and individuals (so-called impact investors). These private financing flows to developing countries have increased significantly in recent years. With private funding from OECD countries amounting to around USD 60 billion in 2013, they still fall far short of their estimated potential of USD 500 billion.

2) Improving the conditions for private investment in developing countries

This particularly encourages investment by local companies. Deficits on local financial and capital markets, such as short credit terms and the lack of venture capital, are a hindrance to private investment. Investigations in the field of climate finance demonstrate the potential of local private investments: only 27% of global climate funding comes from OECD countries, whereas an estimated 73% of financing flows come from the developing countries themselves.

State-owned development banks as risk takers and pioneers

State-owned development banks are often perceived as having a pivotal function between the public and private sector, and can act on both levels. They use their developmental policy, as well as country and sector-specific experience and reputation, to mobilise private investors. By using instruments such as guarantees, subordinated loans and the backing of riskier tranches of structured funds, they reduce the risks for private investors. State-owned development finance institutions, which work directly with the private sector, generally integrate private investors by applying funding limits, meaning that in addition to public investment, other (private) investors or borrowers or recipients must contribute their own capital or take on part of the project costs. Anchor investments send positive signals to potential co-investors, build trust and often pave the way for private investment by taking on high initial costs.

Technical support acts by improving quality and thereby also reducing risk. By selecting their investment projects, development banks specifically improve the conditions for private investment, for example by investing in education and transport infrastructure, but especially by promoting local financial systems and capital markets.

Limits of capital mobilisation

According to an IFC study from 2013, one dollar from the IFC mobilises on average three additional dollars from other investors in climate finance. Other public financiers report similar figures for climate and development financing.

Yet state-owned development finance institutions come up against limits, in particular when mobilising private investors, stemming from the trade-offs between the increased involvement of private investors and public-sector promotion. The greater the mobilisation effect is, the more pressing the question becomes as to whether a project would have been implemented even without public funding. In contrast, it has to be weighed up with other developmental projects whether the achieved, and in some cases very low, mobilisation effects justify the individual transaction costs of the mobilisation, e.g. structuring costs, or if purely public financing would be more appropriate.

Conclusion

In view of the increasing challenges, mobilising private capital is becoming more and more important in development and climate policy. It should therefore always be analysed as to whether private capital can be involved in a public-sector project. However, given the limits of mobilising private investors, maximising this mobilisation is not crucial – but purposefully integrating these investors and improving conditions for local private investment, including the development of local capital markets. ■

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