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IDOS DISCUSSION PAPER 14/2024

Private Sector Mobilisation: Turning a Pipe Dream into Reality

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Bonn 2024

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Published with financial support from the Federal Ministry for Economic Cooperation and Development (BMZ), based on a resolution of the German Bundestag.

Suggested citation:
Zattler, J. K. (2024). *Private sector mobilisation: Turning a pipe dream into reality* (IDOS Discussion Paper 14/2024). Bonn: German Institute of Development and Sustainability (IDOS). https://doi.org/10.23661/idp14.2024

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IDOS Discussion Paper / German Institute of Development and Sustainability (IDOS) gGmbH
ISSN 2751-4439 (Print)
ISSN 2751-4447 (Online)
ISBN 978-3-96021-239-3 (Print)
DOI: https://doi.org/10.23661/idp14.2024

© German Institute of Development and Sustainability (IDOS) gGmbH
Tulpenfeld 6, 53113 Bonn
Email: publications@idos-research.de
https://www.idos-research.de

Printed on eco-friendly, certified paper.

The institutes of the Johannes-Rau-Forschungsgemeinschaft are institutionally funded by the state of NRW.

Abstract

Achieving the United Nations Sustainable Development Goals (SDGs) and meeting global climate targets will necessitate unprecedented levels of investment, particularly in developing countries. A substantial portion of this investment must be sourced from the private sector, given the scale of the financial requirements and the limitations of public funding. Ever since gathering in Addis Ababa for the Third International Conference on Financing for Development in 2015, the international community has held lofty ambitions in this regard. The event set out to mobilise private sector investment on a scale of "billions to trillions". So far, that aspiration has remained a mere pipe dream. For this to change, a greater focus needs to be placed on increasing the mobilisation rate (i.e., mobilising more private finance for each dollar of concessional finance). Further effort is also needed to establish a more enabling environment for private investment. In that respect, climate-related transformation offers the greatest opportunity. This approach is especially relevant for countries in fiscal and debt distress.

This paper builds on experts' recommendations which have converged in recent times. The G20 Independent Expert Group (IEG) emphasise that in emerging and developing economies (EMDEs), the essential building blocks on which markets are founded are often lacking. They argue for working more "as a system" by using all available support instruments coherently and by aligning this support as much as possible with the policies of partner governments. Experts also call for more efficient use of blended finance and smarter risk taking, for example by developing new (aggregated) financial products.

While these proposals are crucial, some questions remain unanswered. In particular, the trade-offs are often not spelt out nor is it always clear what such proposals would mean for the business and operational models of development finance institutions (DFIs), encompassing corporate objectives, budgets, and incentive structures. This paper also outlines the main challenges linked to implementation, including how to function more "as a system" (e.g., between sovereign and non-sovereign lenders), how to align donors more closely with the policies and investment programmes of partner governments, and how to better balance blended finance approaches with the support for policy reforms enabling private sector investment. The paper explores how to use policy-based lending (PBL) more efficiently to improve market conditions (and avoid the building up of more debt through blended finance), how to strengthen blended finance policies, and how to increase the lending capacity of development banks through smarter risk taking.

It is essential to acknowledge that the approach outlined in this paper is not intended as a prescriptive blueprint. While undoubtedly ambitious, it should be adopted selectively, based on available opportunities and specific country contexts. Nevertheless, the proposals presented in this paper warrant serious consideration and should be pursued wherever feasible. This paper outlines how shareholders can take these proposals forward in the boardrooms of national and, in particular, international development banks. The first step should be to foster dialogue with the relevant management teams to agree on an implementation plan.

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Abbreviations

CCDR	Country Climate and Development Report
CPSDs	Country Private Sector Diagnostics
EMDEs	emerging and developing economies
IEG	G20 Independent Expert Group
IFI	international financial institution
IHLEG	Independent High-Level Expert Group on Climate Finance
JETP	Just Energy Transition Partnership
LIC	low-income country
MDB	multilateral development bank
MIC	middle-income country
MIGA	Multilateral Insurance Guarantee Agency
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
PCC	private capital catalysation
PCE	private investment enabling
PCM	private capital mobilisation
PPA	power purchase agreement
SDGs	Sustainable Development Goals
UNCTAD	United Nations Conference on Trade and Development

1 Introduction

Achieving the UN's SDGs and the climate goals will demand unprecedented levels of investment, particularly in developing countries. Although methodologies and criteria differ, the annual financing gap is commonly estimated to range between US$2.5 trillion and US$4.2 trillion by the likes of the World Bank, UNCTAD, OECD and the Independent High-Level Expert Group on Climate Finance (IHLEG). Specifically, the latter estimates that EMDEs other than China will need to spend about US$2.4 trillion per year by 2030 to meet the abovementioned targets. The gap has widened recently due to the COVID-19 pandemic and Russia's war on Ukraine, and for this to be narrowed or closed, most of the financing will have to come from the private sector. Financing needs and opportunities are greatest in the sectors key to decarbonising economies. The IEA (2023) highlights that annual investment in clean energy within developing countries (excluding China) must increase sevenfold by the early 2030s, with 60% of the required funding expected to come from the private sector.

There are two broad ways of catalysing private investment. The first is through private capital mobilisation (PCM), which entails using concessional resources in the form of blended finance or public guarantees to incentivise investment. The second is through private investment enabling (PCE), which aims to improve the market conditions for private investment (e.g., through fiscal and regulatory reforms). In what follows, we use the term private capital catalysation (PCC) to refer to the aggregate of these two components.

To date, PCM has been at the heart of efforts focusing on mobilising individual transactions through the use of blended finance. These measures have seen only limited success. For instance, in recent years, climate finance mobilisation has averaged less than US$15 billion annually, according to OECD statistics. Mobilisation rates, meaning the private money mobilised by public funds, have been low. The IEG (2023b) estimates that multilateral development banks (MDBs) have historically mobilised about 60 cents of every dollar of their own commitments.

Against this backdrop, the situation looks dire. The amount of private funds mobilised so far is tiny compared to what is needed. The IHLEG (2023) proposes a fivefold increase in concessional finance by 2030, partly from bilateral official development assistance (ODA) and partly from innovative sources such as special drawing rights (SDR) reallocation, carbon markets, and international taxation. However, such an increase in concessional finance would be difficult to achieve in a context of tight fiscal constraints in donor countries. It would also raise questions about fiscal and debt sustainability. The IMF (2023) recently sounded the alarm, warning that "expenditure-based policies" to achieve net-zero targets by mid-century will become increasingly costly, potentially increasing public debt by 45-50% of GDP for a representative large-emitting country. It would also add significantly to external imbalances and put unwanted upward pressure on exchange rates.

Therefore, alternative means of PCC should be explored. One such option is to make better use of concessional finance by increasing the mobilisation rate. The IEG (2023a) suggested targeting a mobilisation rate of US$1.5 to US$2.0 for every dollar lent through non-sovereign arms. Another option is to increase PCE by further improving market conditions, with the IEG proposing a target of $260 billion per annum.

This paper is structured into three main parts. Section 2 argues that, in recent years, experts' views on PCC have converged. It outlines the key elements which could serve as building blocks for a new, more effective approach. However, their implementation will not be easy. Part (B) summarises

the related challenges for the business and operational models of MDBs and DFIs[1]. Aimed at shareholders and policymakers interested in implementing a new approach to PCC, Part (C) suggests specific issues to be taken up in the respective boards and other governing bodies of both international and national development institutions. The paper also pays particular attention to the challenges associated with the green transition, not least because they represent important investment opportunities for private investors.

2 Building blocks of an enhanced approach

In recent years, there has been a notable convergence of experts' views on how to achieve private investment at scale. These opinions are inspired by past reform experiences, most notably "IFC 3.0", a comprehensive reform process that underpinned a capital increase approved by shareholders in 2018. Since then, IFC 3.0 has been partially implemented. Notably, the recommendations of the IEG, established under the Indian presidency of the G20, were largely based on elements of IFC 3.0. Many of these elements can also be found in the reports of other expert groups, such as the IHLEG and international organisations such as the IEA.

A key aspect of this approach is to move beyond current practice, which focuses on facilitating individual investments by simply reducing risks and capital costs through concessional blended finance and public guarantees. Instead, these reports, and most explicitly the IEG, demand working more "as a system", by using all available support instruments coherently and aligning this support as much as possible with the policies of partner governments. Experts call for more efficient use of blended finance and smarter risk taking, for example by developing new (aggregated) financial products. They also insist upon greater effort to develop local capital markets.

The remainder of this section elaborates on these elements. It does not serve as a summary of the various expert reports; rather, it extracts broadly shared elements from the relevant contributions and places them in context.

2.1 Creating markets through a comprehensive set of instruments

The above-mentioned experts (hereinafter referred to as "expert groups") highlight that in EMDEs, the essential building blocks to establish markets are often not in place. Therefore, the IEG (2023a) proposed increasing PCM, in particular by improving mobilisation rates, as well as enhancing PCE by unlocking private investment through fiscal and regulatory reforms, complementary public investment, and systematic upstream diagnostics, as well as the provision of downstream advisory services and technical assistance to firms and public institutions. Most of these instruments have been used already. However, as the IEG (2023b) points out, there has been a disconnect between the top-down approach (e.g., technical assistance for policy reforms) and the bottom-up perspective of investors. Advisory services have been provided in a fragmented manner, with little linkage to key policy reforms. To achieve greater synergy, all available support instruments need to be integrated into a coherent approach aimed at closing the gap between private and social returns, thereby improving relative risk-adjusted returns. This would address investment readiness

1 In this paper, the term "development finance institution" is used to refer to public banks that lend to and invest in non-sovereign entities. The term "development bank" applies to public lenders to sovereigns and includes multilateral development banks, regional development banks, and national development banks. The terms "development banks" and "multilateral development banks" are also used as umbrella terms for institutions with sovereign and non-sovereign arms, such as the World Bank Group or the Asian Development Bank.

at scale and overcome the acute shortage of bankable projects. This approach has the added advantage that the benefits would accrue to all investors, not just those targeted by blended finance or guarantees, including domestic investors.

A key objective of this approach is to establish a more enabling environment for private investment. An important starting point is to clarify what is holding back private investment in specific country contexts, or, in other words, determining how to increase the risk-adjusted return expectations of potential private investors by addressing crucial barriers, such as:

- The cost of capital. Capital costs are significantly higher in EMDEs, especially in low-income countries (LICs). The IEA (2023) has calculated that these costs for a typical utility-scale solar project can be two to three times higher in key emerging markets than in advanced economies reflecting real and perceived risks at the country, sector, and project level. Notably, high interest rates in recent years have exacerbated this problem.

- Macroeconomic and political instability in the host country.

- Higher costs of doing business due to poor infrastructure, regulatory deficiencies, reduced human capital, and the general business environment.

- Lack of investor experience in many EMDE markets.

- Underdeveloped financial markets, which makes it difficult for investors to manage key risks such as foreign exchange risk and equity exit risk.

Improving the environment for private sector investment, and thus minimising the need for blended finance, is particularly important in times of acute fiscal and debt distress, and when markets need to be transformed rapidly (see Box 1 below illustrating energy transition issues). Many economic and regulatory policies are heavily biased in favour of highly polluting investments, when the opposite is actually needed. Investment in modernising and greening transport, energy, and agriculture is largely held back by inappropriate fiscal and regulatory policies. For example, fossil fuel subsidies, regulations that prevent market access for green technologies, and higher tariffs on green goods are still prevalent in many countries.

MDBs should play a key role here, starting with the systematic use of country-level analysis. Taking the World Bank as an example, its Country Private Sector Diagnostics (CPSDs) are a good starting point; however, it is important to note that they need to be further improved to provide a granular analysis of country-level barriers to private investment, necessary complementary public investments, and specific legislative or regulatory policies that constrain development. The results thereof must feed into other analytical tools, such as the Country Climate and Development Reports (CCDRs) and the World Bank’s country programmes.

Box 1: Energy transition

Many countries are keen to decarbonise their economies, with the energy sector playing a key role. All countries, and especially EMDEs, face many development challenges, have limited administrative capacity and resources, and suffer from political economy constraints. As such, they need to focus on specific areas and sectors, as well as the most binding constraints that can be softened in the short term. In the context of the energy transition, the question is what can be done quickly to improve the investment environment for renewable energy. The main factors for consideration here are outlined below.

Clear government commitment

Financing for clean energy projects will not flow without credible government commitments and climate change transformation planning. General commitments, such as those made in countries' climate commitments (nationally determined commitments (NDCs)), need to be translated into clean energy transition plans and targets.

Supportive fiscal policies

Unlocking private capital for the energy transition requires comprehensive fiscal reforms. A price on carbon, or regulatory and policy measures with equivalent effect, such as feed-in tariffs, help to steer investment decisions towards cleaner and more efficient renewable energy technologies. Among the issues deterring investors are subsidies that discourage clean energy investments. The implementation of fossil fuel subsidy reform and feed-in tariffs is therefore important.

Supporting regulatory policies

Standardisation of power purchase agreements (PPAs) is another important factor to bear in mind. Such agreements should be long term and allow power producers to charge cost-reflective energy tariffs. Pegging PPAs to hard currency reduces exchange rate risk for investors. According to the IEA, key success factors here include competitive auctions for new capacity combined with a creditworthy off-taker. Removing barriers to corporate PPAs, where companies contract directly with renewable energy producers, is another way of providing strong incentives for private investment. This also helps to ensure predictable procurement procedures and clear land rights, and to avoid lengthy procedures for licensing. However, credible national counterparties for PPAs are often not available. The World Bank (2017) has identified a number of ways to address the issue.

One such example is the Just Energy Transition Partnership (JETP) with South Africa where partners identified barriers to private investment in renewable energy that could be addressed through regulatory reform. A significant barrier was the existing licensing threshold for embedded generation. To address this challenge, the South African government has liberalised generation capacity for the private sector, yielding encouraging results. The South African government signed off 14.5GW of new renewable energy projects in 2023, with a further 51.5GW in the pipeline, compared with only 54GW of total installed capacity across all energy types in 2022.

Complementing public investment

In many EMDEs, weak electricity infrastructure leads to unreliable access for users, which represents a major risk for investors. Investment in clean energy generation depends on timely grid expansion, along with energy storage and other options to enable the integration of variable renewables. According to the IEA (2023), more than 90% of investments in EMDE grids are the responsibility of state-owned enterprises, many of which are under severe financial pressure and lack access to capital. At the same time, private sector involvement in electricity networks is mostly limited to the distribution sector, although private sector financing of energy storage projects is increasing.

2.2 Aligning development agencies with the policies of partner governments

Donor contributions need to be better aligned with the policies and investment plans of partner governments. As Le Houerou et al. (2023) put it, all partners must sing from the same hymn sheet. This entails giving the partner country more control. It also means reducing fragmentation, increasing efficiency (e.g., by pooling the knowledge of all partners), engaging strategically with governments and private sector clients, sharing project development costs, harmonising standards or agreeing on mutual recognition (as recently seen in the agreement reached between the EIB and the EBRD), and pooling risks across the system. Country platforms, such as JETPs, are promising vehicles for implementing this approach. The JETPs have underlined the importance of all partners sharing a strategic vision for change and government involvement, ideally at a high level with a clear allocation of responsibilities.

Most importantly, sovereign and non-sovereign lenders need to work more closely together. The fundamental first step in doing so is to jointly identify policy, regulatory, and other constraints hindering private investment. Vitally, this brings together public and private sector perspectives. In this regard, public authorities need to provide both PBL and the public investment necessary to leverage private investment on a large scale. Close public-private cooperation and coordinated investment are key to creating and improving markets, which is particularly true when it comes to decarbonising sectors such as transport and energy.

2.3 Increasing efficiency through aggregation and smarter risk management

The efficiency of development banks could be enhanced through sharing access to tools and instruments and smarter risk management. One concrete example of smarter risk taking is the auctioning of concessionary funds for specific development purposes. Another potentially fruitful step would be to further develop the Global Infrastructure Facility (GIF) in pursuit of the much-needed consolidation of project preparation facilities, thereby also facilitating access for EMDEs.[2] More generally, expert groups have suggested the creation of cross-MDB mobilisation platforms. Indeed, this could help to deploy blended finance more efficiently and overcome the reluctance of institutional investors to invest in developing countries. A sufficiently large pool of assets would provide risk diversification and allow investors to assess expected risks and returns.

Expert groups advocate for a more efficient use of concessional finance, in particular through the greater use of blended finance (as well as guarantees) at portfolio and country levels. As Murton (2023) points out, using concessional capital at the project level limits its ability to change the conditions that make projects difficult to finance in the first place. Specifically, these conditions include the lack of a project pipeline, small ticket sizes, persistent regulatory friction, and high political and currency risk. Concessional resources will be used more efficiently if they are focused on policy reforms and other investment barriers at the country level, for example through country platforms.

Expert groups suggest that the use of guarantees should be expanded and made more efficient. Guarantees can mitigate various risks, such as sovereign credit risk, political and regulatory risk, currency volatility, and early-stage risks. They can be an effective instrument to mobilise private capital. According to the IEG (2023b), on average, every US$1 of World Bank guarantees has mobilised US$4 of investment finance. However, despite some progress being made, guarantees

2 With the same objective, the Center for Global Development (2024) proposed establishing the Accelerator Hub, a one-stop shop for a range of technical assistance programmes and initiatives.

have been underutilised. The IEG (2023b) estimates that, historically, the International Bank for Reconstruction and Development (IBRD) has used sovereign guarantees for less than 0.7% of its annual loan and grant commitments. It proposes increasing the use of guarantees to 25% of MDB portfolios by 2030. The relative underuse to date can be attributed to two main factors. First, currently guarantees do not have an advantage over loans in terms of capital requirements (i.e., in both cases, capital is required to cover the full amount of the exposure). Simply put, applying the same capital requirements to guarantees and loans reduces the incentive to use them. Second, the guarantee landscape is complex and involves high transaction costs, both for guarantee providers' staff and for clients.

The treatment of risk capital requirements for guarantees in relation to loans should be reconsidered. Guarantees could be accounted for as a fraction of the loan equivalent relative to a country's annual lending envelope. More standardisation and consolidation would also help, replacing the current patchwork of different processes, rules, and standards. The IEG (2023a) suggests that the Multilateral Insurance Guarantee Agency (MIGA) should offer insurance that offloads MDB risk at the portfolio level, freeing up more capital for lending. Other proposals include standardising guarantee contracts and combining different types of guarantees, such as MIGA guarantees and sovereign guarantees from MDBs, and strengthening the MIGA's catalytic role by transforming it into a platform that also serves other institutions. The World Bank has already announced its intention to simplify guarantee products into a single comprehensive menu that would allow clients to easily identify and select the instruments best suited to their needs.

Guarantees could also be used to address macroeconomic and exchange rate risks. The Bridgetown Initiative (2024) argues that this is the main factor holding back large-scale private investment in renewable energy. Its proponents point out that institutional investors have a strong preference for investments denominated in hard currency; even in development finance, some 80-90% of MDB lending is still in hard currency. While it is difficult to determine how much investment could be unlocked by reducing exchange rate risk, there is little doubt that there is value in improving current risk mitigation and hedging facilities. At present, the cost of hedging, if there is indeed any hedging available in the market, is prohibitive and the facilities that do offer hedging (such as TCX) are too small. There are no easy solutions to mitigate foreign exchange risk. In the short term, MDBs should provide guarantees to onshore local currency hedging platforms (to be developed) or to existing hedging mechanisms. The more viable longer-term solution would be to deepen local capital markets (see Section 2.4 below).

2.4 Mobilising capital market funds and deepening local capital markets

To catalyse private capital at scale, greater emphasis should be placed on engaging both institutional investors and domestic financial markets. Green and sustainable bond issuance has grown rapidly in recent years, thus institutional investors have become increasingly interested in investment opportunities with the potential to deliver attractive risk-adjusted returns while mitigating environmental, social, and governance (ESG) risks. A key constraint to further growth is that capital markets in most EMDEs are very shallow in terms of sophistication, depth, and liquidity.

MDBs are well placed to help bridge the gap between the supply of investable assets and the demand of private investors. While there are no quick fixes here, they should prioritise certain areas. First, sustained efforts should be made to improve regulatory frameworks and capital market infrastructure (including insolvency laws, prudential regulations, market transparency and integrity safeguards, investor protection, and market supervision) by supporting capital market authorities and issuers, adopting green taxonomies and frameworks, and broadening the network of domestic financial intermediaries and investors.

Second, investors should be provided with access to EMDE assets in a more standardised and scalable format. This could be done through intermediary vehicles that aggregate projects, thereby diversifying and reducing risk. Project aggregation platforms and securitisation vehicles can overcome the asymmetry between the relatively small size of most projects in EMDEs and the relatively substantial minimum investment required by large institutional investors. These platforms, such as the One Planet Managed Co-Lending Portfolio Program (MCPP), pull together a large number of smaller projects and can use concessional financing to mitigate some of the credit risk. The result is a standardised, investment-grade, multi-asset portfolio that can attract the largest institutional investors. Development cooperation should help by setting up such vehicles with a blended fund structure and by assisting in developing a market for institutional investors. In particular, the development of a market for green, social, sustainable, and sustainability-linked (GSSS) bonds offers a particularly attractive opportunity. GSSS bonds have the potential to mobilise private capital on a large scale. According to the IEA (2023), there are more than US$2.5 trillion in ESG-related investment funds worldwide, but almost none of this capital flows to EMDEs. Growing the GSSS market will require robust third-party certification and monitoring, standardised industry guidelines, harmonised taxonomies, cost-effective regulation, and better instrument design. This focus on mobilising capital market funds would necessitate some change in the business model of DFIs, which is fixed on own-account investment (i.e., originating projects with own funds and holding them to maturity (known as the “originate-to-hold” model)). Instead, they would move towards an “originate-to-share” model. According to this model, riskier investments would continue to be financed from DFIs’ own funds, while more standardised operations would be sold to private investors before maturity.

Third, more accurate information about investing in EMDEs is important because potential investors are largely unaware of the risks involved. Poor information feeds into high-risk perceptions and drives up the cost of capital. The G20 has therefore supported efforts to expand access to the Global Emerging Markets Risk Database, which pools credit information from MDBs and DFIs to provide aggregate risk statistics. As a result, this reform is already underway.

Fourth, the mobilisation of domestic resources should become a priority. Volz et al. (2024) point out that there is significant untapped potential of domestic resources flowing out of the country into hard currency assets abroad. In particular, local pension funds and local bank deposits could be an important source of development finance. This could become a substantial pillar for developing local capital markets and mobilising local currency funds to finance development projects. It is therefore crucial that the abovementioned ways of mobilising institutional investors are targeted at both international and local investors. In addition to widening the pool of potential investors, this would help to deepen local capital markets. It would also mitigate exchange rate risks, as tapping local capital for local currency assets would serve as a natural hedge. Meanwhile, deeper local capital markets are particularly important when scaling up domestic private investment in the energy transition. As the IEA (2023) notes, in some EMDEs, such as China and India, domestic capital – rather than foreign capital – has so far been the main source of private capital for this transition. One reason for this may be that project-related revenues from energy transition projects in EMDEs are typically denominated in the local currency.

International development banks can help to address these issues by assisting national development banks to raise domestic capital through credit enhancement for local currency bond issues or by providing capital. In addition, they could support development banks in EMDEs with technical assistance, capacity building, and/or the provision of guarantees for demand deposits.

3 Challenges for business and operational models of MDBs and DFIs[3]

The above section marked an attempt to extract and interpret the main reforms proposed by various expert groups. While these proposals are a useful starting point, many questions remain unanswered. Moreover, the necessary trade-offs are often not clearly explained and it is not always obvious what these proposals mean for the business and operational models of MDBs and DFIs, including with respect to corporate objectives, budgets, and incentive structures. The following section outlines some important implications of these proposed reforms, particularly the pain points.

3.1 Working as one institution

Tight cooperation, even within an institution like the World Bank, is complex and requires a common understanding on many issues, including economic policymaking and the role of the state. MDBs, and the World Bank in particular, have adopted what some have called a "let a thousand flowers bloom" approach, where all kinds of sometimes contradictory economic policy recommendations can flourish. Departments such as the Vice-Presidency for Sustainable Development (SD), the Vice-Presidency for Economic, Financial and Institutional Affairs (EFI) and the Research Department (DEC) have very often followed different lines of thinking. This contrasts with the situation at the IMF, which has developed corporate strategies for key areas of its mandate.

While diversity of thought can foster creativity, it can also be detrimental to coherence and effective implementation. With that in mind, the new approach outlined in Section 2 would involve the challenges – and opportunities – of initiating new research on industrial policy and arranging constructive cross-cutting dialogue to develop common views. Such an MDB-driven process should address questions about the merits of industrial policy approaches, covering drawbacks and practicality. Such queries include: What are the conditions, particularly political and administrative, under which a particular industrial policy can succeed? How can the transition towards a green economy simultaneously boost local production (e.g., regarding the rolling-out of solar capacity)? How can technology transfer and local employment be maximised? How can local production and linkages be fostered?

3 In this paper, the term "development finance institution" is used to refer to public banks that lend to and invest in non-sovereign entities. The term "development bank" applies to public lenders to sovereigns and includes multilateral development banks, regional development banks, and national development banks. The terms "development banks" and "multilateral development banks" are also used as umbrella terms for institutions with sovereign and non-sovereign arms, such as the World Bank Group or the Asian Development Bank.

Box 2: Industrial policy and sectoral focus

Among both policymakers and researchers, there is renewed interest in industrial policy approaches, including the role of the state and its interactions with the private sector. Notably, policymakers are keen to make global supply chains more resilient. They are also under pressure to orient their economies toward decarbonisation. Many governments have abandoned old conventional wisdom, which for decades emphasised the primacy of free trade and capital flows, deregulation, privatisation, and the adoption of other pro-market policies and industrial policies of various kinds. Now, there is talk of a global renaissance in industrial policy.

At the same time, a growing number of economists are calling for a new balance to be struck between markets and the state. The Berlin Declaration (2024), signed by dozens of leading academics, is a valuable recent example thereof. Janeway (2024) draws attention to a recent review of the literature by economists Réka Juhász, Nathan J. Lane, and Dani Rodrik, who outline a range of approaches used to induce structural change in market economies by shifting incentives for competition in sectors deemed strategic – as opposed to identifying specific "national champions". Many economists feel that the space between microeconomics, which focuses on the behaviour of individual agents, and macroeconomics, which deals with the behaviour of statistical aggregates, has been largely neglected, particularly in terms of how it serves as the dynamic context in which economic policy is played out. A sectoral focus may be most relevant in contexts requiring large-scale transformations and the management of externalities – such as the energy transition (see Aghion et al., 2024) – where states must leverage significant private investment.

It could be argued that industrial policy is particularly problematic for EMDEs due to structural weaknesses (e.g., weak infrastructure, a less skilled labour force, and poor institutions that affect the investment environment). It would thus be impossible for them to overcome these weaknesses in the short term. Instructively, according to Le Houerou et al. (2023), private sector investment performance in EMDEs has been poor despite some improvement in the business environment in these countries (Le Houerou et al., 2023). For two reasons, the challenges go beyond the general business environment as measured, for example, by the World Bank's Doing Business Report or the OECD's FDI Restrictiveness Index. The first reason is that far-reaching changes are needed rather than marginal improvements, which can only be achieved within a limited scope, such as a specific sector or subsector. The second is that resources need to be shifted from one area (e.g., brown investments or old industries) to new ones (e.g., green investments and industries).

The renewed debate on economic policy has much in common with the current debate on PCC. Similarly, recent industrial policy initiatives reflect the market creation approach outlined above. The discourse is now moving to sectoral and meso levels, while an emphasis is being placed on the role of the state in guiding the transformation process. We may be at the beginning of a new phase where old wisdom and practices are being challenged and modified. Political economy issues, rent-seeking risks, and fiscal and administrative constraints need to be taken seriously, especially in developing countries: where past practices have not worked, new approaches should be seriously explored and countries should be encouraged to experiment accordingly.

Working as one institution becomes particularly challenging when it comes to cooperation between sovereign and non-sovereign arms, as vastly different cultural and institutional barriers must be overcome. For example, in the World Bank Group, the IFC and the MIGA are institutionally separate from its sovereign arms (the IDA and the IBRD). The IEG (2023b) emphasises that there has generally been a disconnect between the top-down approach of the sovereign arms (and policymakers) and the bottom-up perspective of the non-sovereign arms (and investors). Advisory services have been provided in a fragmented manner, with the link between policy reform and the direct impact on private investment limited. There has also been a shortcoming in the operational interaction between the two. This needs to change drastically if co-creation of investment opportunities and project pipelines is to become a reality (e.g., through joint client engagement, joint governance mechanisms, joint programming, joint metrics, targets and monitoring, as well as

through appropriate staff incentives, enhanced inter-institutional mobility, and the alignment of reporting lines).Sovereign and non-sovereign arms working side-by-side is particularly important in PBL.

3.2 Development partner alignment

To bring about real change and catalyse large-scale private investment, donors need to align themselves more closely with the policies and investment programmes of partner governments. This will require significant changes in the way development agencies work. The starting point here concerns the perspectives of partner countries, as well as the acquisition of in-depth knowledge of the engagement of other donor agencies. This would entail adapting formats, procedures, and policies accordingly as well as donor agencies developing a different kind of expertise, focusing less on project management and more on sector knowledge and policy dialogue. Importantly, country systems should be used wherever possible, with the IEG (2023b) suggesting that operations should be channelled through country systems in at least 50% of country clients.

MDBs need to play a key role in orchestrating this alignment process. This means, inter alia, greater coordination on diagnostics, policy dialogue, and related technical assistance. They can also drive the process of harmonisation or mutual recognition of standards, thereby reducing transaction costs especially for partner authorities. Relatedly, the IMF and the World Bank need to overcome rivalries and dovetail macroeconomic, sectoral, and socio-economic analyses. This is particularly important for climate-related analytical work. Lessons can be learned from the JETPs in which such an integrated approach is already being piloted.

3.3 Policy-based lending

Policy-based lending, which provides budget funds to partner countries in exchange for policy reforms, is the most important instrument available to enable private investment. Unlike investment lending, the reforms supported by PBL do not incur debt and can even create fiscal space. Therefore, if well designed, initiatives of this type can be particularly attractive to countries in debt distress.

Development banks face two major challenges in this regard. First, policy reforms are often difficult to design, and require long-term engagement. This is compounded by the need to design them in a way that is socially equitable and politically feasible. As Black et al. (2023) explain, this demands in-depth analysis, especially at the country level, including impact analysis and the identification of trade-offs between instruments. This can only be effective if the MDBs – in close cooperation with the IMF – take the lead in developing expertise, conducting in-depth analysis, enhancing country capacity to provide assistance, and building productive and intensive policy dialogue.

Second, partner governments are often reluctant to undertake major policy reforms. Development banks and MDBs, in particular, can facilitate or ease such reforms, by providing additional support and finance. However, these additional resources are often insufficient to tip the balance. In that regard, coordination with other development partners, as outlined above, can help by increasing overall donor financial support and leverage. In addition, MDBs need to find ways to allocate their resources, especially concessional resources, in a more flexible way. Doing so would allow more resources to be mobilised for those partner countries wanting to undertake ambitious reforms. In the context of the ongoing MDB reform process, discussions are already ongoing about how to increase such flexibility.

3.4 Blended finance

The DFI Working Group has been set up to strengthen policies, including principles and guidelines regarding the use of concessional finance (see Box 3 below). These policies need to be reviewed in light of the proposed reforms outlined above.

Box 3: Principles and guidelines for the use of concessional finance

The DFI Working Group (2018) defines blended finance as the combination of concessional finance from donors or third parties with normal DFI own-account finance and/or commercial finance from other investors. It has also agreed on principles and guidelines in the following areas: additionality; minimum concessionality; market strengthening; commercial sustainability; and promotion of good standards. The principle of "additionality" is based on the premise that DFIs should contribute beyond what is available in the market (i.e., their contributions should be additional to, and not a substitute for, available private finance). Additionality can take on several forms including risk mitigation, improved project design, better development outcomes, or the embracing of ESG standards. According to the principle of "minimum concessionality", blended finance is used rigorously to avoid "over-subsidisation". The IFC states that concessionality should be no more than what is necessary to induce the intended investment. The principles of "strengthening markets" and "promoting good standards" focus on ensuring that the investments supported by blended finance have a positive development impact beyond individual projects.

First, the use of concessionality must be subject to strict economic principles. As emphasised by Le Houerou et al. (2023), there is a risk that blended finance is simply deployed to "sweeten the deal" by providing financing at below market rates. In theory, the level of concessionality should reflect the size of the externality or market failure being addressed. Measuring the magnitude of externalities is a challenging task, but it should become more manageable once MDB shareholders and management reach consensus – particularly in light of recent reforms. A related consideration is that assessing the extent of concessionality should involve aggregating blended finance contributions from all donors – a practice that is not currently implemented. This is one reason why MDBs and DFIs should enhance transparency regarding the use of blended finance.

Second, the approach to blended finance must better reflect the need to transform markets. The guidelines in place reflect the current practice whereby DFIs focus on individual transactions and operate largely in isolation from their sovereign arms. A good example is the guideline according to which blended concessional finance should only be used when a specific project cannot be structured on a commercial basis. This is misleading because even in such cases it may not be appropriate to use blended finance, especially if the problem relates to inadequate policy and regulatory frameworks. The best approach here would be to address and remedy these adverse conditions. To use an illustrative example, suppose that in a particular country, the electric utility does not set electricity prices above cost recovery, thereby discouraging private investment in renewable energy. In such a situation, private investment could be induced through blended finance, although a better alternative might be to increase electricity prices. Ultimately, a common understanding of when blended finance should be used irrespective of policy distortions is needed.

Third, the current setup is susceptible to free riding by individual DFIs, which occurs when one DFI invests in project preparation and origination, and another DFI "makes the deal" by offering more competitive financing terms. This problem becomes even more acute where the DFI focuses less on individual deals and more on improving market conditions, as project preparation and origination become more important. However, this challenge could be addressed in several ways. One option would be to make the DFI financing the deal pay a fee to compensate for the work done by others upstream. Another option would be to establish a common DFI project preparation facility that can be used by all DFIs.

3.5 Portfolio approach, risk management, and income model

The portfolio approach currently used by most DFIs aims to achieve positive social and environmental impacts alongside sustainable financial returns. It does this by building portfolios with a balanced mix of projects in terms of profitability and development impact. This makes it possible to finance projects with high development impact but very low profitability, as these are cross-subsidised to some extent by highly profitable projects (i.e., low risk and high return).

Reforming the traditional approach to catalysing private capital would have significant implications for the portfolio strategy. Specifically, shifting from a project-based to a market-oriented perspective would influence both the profitability and the development impact of the initiatives undertaken. While the overall development impact would potentially increase, the effect on profitability would be more complex. On the one hand, a market creation approach would imply higher project preparation costs, which would affect profitability. On the other hand, if successful, this investment would pay for itself by generating a stream of new, profitable projects.

Admittedly, this is all merely theoretical at this stage. In practice, there would be caveats to this proposed approach. First, there is a certain time inconsistency to consider in terms of profitability. The costs of project preparation and origination would be incurred upfront, while the stream of new profitable projects would be delayed. Therefore, additional concessional funding would be needed at least until the new approach begins to take off. Alternatively, the numerous existing project facilitation facilities could be significantly consolidated, with the resulting efficiencies redirected towards increased upstream investment in market creation.

Secondly, a more intensive use of DFI capital would have implications for DFI risk management, as DFIs would be required to assume greater risk by managing it more intelligently – for example, through multi-asset structures, securitisation of portfolios, and a shift towards an originate-to-share model. This latter step could also impact the income model, resulting in a shift in emphasis from investment income to fee income. Naturally, it is important that these reforms are more carefully studied and designed, because while they have the potential to leverage more funds with existing capital, the devil is in the detail. If not well designed, there is a risk that public funds will be used to subsidise private investment without significant additionality.

Third, implementing such an approach in low-income countries (LICs) and fragile environments is challenging. In particular, doing so could jeopardise the commitments made by some international financial institutions (IFIs) to hit minimum lending targets in LICs and fragile states. If such targets are to be maintained, the new approach would need to be implemented in different ways. One option here would be to direct blended finance more toward low-income and high-risk markets, including for upstream project preparation. Another option would be to accept that the new approach is going to be too costly, for both clients and donors, if it is applied broadly across difficult environments. This may nevertheless be attractive in areas related to new technologies, such as renewable energy, digitalisation, or e-transport. Creating markets for product lines related to these technologies is generally easier and less costly in middle-income countries (MICs) than in more challenging environments. As costs eventually come down, the technologies could be deployed in LICs.

Fourth, most national DFIs are constrained by domestic banking supervisors who discourage the taking of more and smarter risks; the same is true for international DFIs with respect to rating agencies. As a result, these institutions face similar limitations on their lending as commercial banks. This should be reviewed however, because public development banks are inherently less vulnerable to financial stress and failure, for example, because the share of trade credit in their portfolios tend to be much lower. Indeed, no development bank has experienced major loan defaults, let alone bankruptcy, in the last 50 years. National governments should thus review the status of their development banks. The management teams of international DFIs and their shareholders should begin dialogue with the rating agencies on this very issue.

Finally, a greater development impact could be achieved by shifting portfolios more towards equity investments, including in frontier markets. Returns could be reinvested, for example, through revolving funds. If wisely chosen, these investments could be highly profitable, but only in the longer term. In the short term, this would pose a risk management problem for DFIs, as they currently use a mark-to-market approach, where adverse market movements, such as exchange rate fluctuations, can quickly erode net income. Therefore, some DFIs tend to minimise losses by selling these equity investments as soon as the market turns sour. Giving more weight to equity investments would be desirable, but this would need to be accompanied by a change in risk management (e.g., by abandoning mark-to-market valuation or providing higher risk buffers).

3.6 Debt service crisis

According to the Holland and Pazarbasioglu (2024), some 52% of LICs are in debt distress or at high risk of debt distress. Higher debt levels, combined with global interest rate hikes in 2022 and 2023, have increased debt servicing costs, especially for LICs. The median LIC spends more than twice as much as it did a decade ago on debt service to external creditors as a share of income. Development Finance International (2024) estimates that the debt service burden will continue to rise for almost all affected countries over the next decade, and the IMF warns that these liquidity pressures, if left unaddressed, could lead to solvency problems for many vulnerable countries.

As outlined by Volz, gaining access to international sources of finance is more difficult than ever in an environment mired in deepening sovereign debt crises. Tackling the debt crisis is therefore crucial to enable the mobilisation of private capital but new borrowing must not add to high debt servicing costs. Therefore, when countries need to borrow, they should rely more on concessional financing from the likes of the IMF, MDBs, or bilateral donors, which offer lower interest rates. In addition, policy adjustments, such as tax reforms, can help to raise revenues. As emphasised above, donors and MDBs may assist by providing more support through PBL thereby boosting growth and revenue collection without incurring new spending. Support for fossil fuel subsidy reform is a good example here, spurring growth, modernising the economy, and freeing up public resources.

3.7 Staff incentives and organisational changes

The nature and scale of the envisaged reforms will not be achievable without a major overhaul of development banks' organisational structures and staff incentives, including with respect to remuneration, bonuses, performance evaluation, and career development. First, MDBs/DFIs need to build capacity and teach skills as a market creation approach requires in-depth knowledge of technological and sectoral trends. This enables people to understand the key bottlenecks of private investment, as well as how far countries are from the frontier and, therefore, whether market creation can succeed in a particular context.

Second, there are important institutional barriers that need to be overcome. The most significant of these is that between sovereign and non-sovereign arms (see above). In addition, macro and fiscal expertise is in some cases kept separate from sector and project-level expertise. For example, at the World Bank, in most cases (95%), the unit charged with leading the organisation's climate work and the unit charged with policy-related reforms at the macro and fiscal levels are housed in a separate vice presidency (SD). According to this organisational chart, there is no reporting line between the part of the institution that formulates the World Bank Group's climate policies and the part that implements policy reforms.

4 Key next steps and issues to be taken up with DFIs

The IEG (2023b) put forward concrete proposals, which have been widely echoed by other expert groups. It has also suggested the establishment of a mechanism to advise and independently assess the implementation of the proposed roadmap in the first year, and shareholders of national and international MDBs and DFIs should follow suit. This is not to say that the market creation approach outlined above should be adopted uniformly across the board. The approach may not work well in all circumstances. Nevertheless, the proposals should be taken seriously and the follow-up should be undertaken where possible. The first step should be to establish dialogue with management teams to agree on an implementation plan. Below is a list of suggested questions that shareholders may ask when initiating dialogue. The list overlaps with the list of recommendations presented in the IEG report (2023b). However, it focuses exclusively on PCC issues and those relevant to the boards of development banks.

Table 1: Implementation plan: issues to be taken up by shareholders with MDB/DFI managements

Issues	***Considerations***
Develop proposals for measuring PCE as well as PCM mobilised through policy and regulatory reforms as well as through portfolio guarantee approaches.	Development banks in cooperation with other institutions such as the OECD.
Formulate ambitious mobilisation objectives, including on mobilisation rates.	
Provide a granular analysis of country-level obstacles to private investment, complementary public investments needed, and specific legislative or regulatory policies that constrain private investments, particularly climate-related ones.	Multilateral DFIs, particularly the IFC should take the lead. The CPSDs should also be further refined, building on “if/then” matrices that estimate the potential of unlocking private investment, based on policy reforms. This should systematically feed into the country strategies of the IFC and the World Bank.
Make sure that relevant diagnostic work as well as country programmes are based on that analysis, and that support instruments are applied in an integrated way.	
Establish country platforms and align instruments where possible, and enhance the use of country systems.	MDBs must steer this process.
Where possible, share tools and instruments with other development banks.	MDBs to take the lead.
Engage more in the establishment of project aggregation platforms and securitisation vehicles; present an options paper to move towards an “originate-to-share” model.	MDBs to take the lead.
Present a policy on guarantees (with the objective of scaling up their use to account for 25% of MDB portfolios by 2030, in line with the IEG recommendation) containing the following features: - addressing capital requirements; - rules as to when guarantees should be used; - proposals to consolidate guarantees; - proposals on how to use guarantees addressing different risks in a harmonised way; - proposals on how to use them more at the portfolio and country levels; and - proposals to provide guarantees to local currency onshore hedging platforms (to be developed) or to existing hedging mechanisms.	

Issues	*Considerations*
Give special importance to the development of local capital markets.	
Initiate cross-sectional research on industrial policy, focusing on the conditions of success. Special focus should be applied to identify best practices among developing countries to maximise employment, value added, and welfare when transitioning to a greener economy.	The World Bank should take the lead (e.g. by dedicating the next World Development Report to this issue).
Present a plan for sovereign and non-sovereign arms to work closely together (client engagement, programming, metrics/targets/monitoring, staff incentives, and organisational structures/reporting lines).	
Embark on an alignment process: coordinate much more on diagnostics, policy dialogue, and related technical assistance; and harmonise or mutually recognise standards.	MDBs should orchestrate this process. The IFC should leverage its statute and convening power to drive reforms across MDBs and DFIs focusing on standardisation of project documentation, project terms, impact measurement, due diligence, and credit and ESG risk ratings. The World Bank and the IMF should present a joint note explaining how they will enhance cooperation regarding climate-related work.
Systematically deploy PBL (open to other donors), particularly that related to green macroeconomic, fiscal, and regulatory policies.	They should present a plan, with MDBs taking the lead in certain countries. The MDBs' country strategies should explain precisely what reforms would unlock private investment and how those would be addressed through MDB dialogue and instruments. Special emphasis should be given to climate-related investments, most importantly in the energy sector.
Adapt policies to embrace the use of concessional finance, disclose explicit and implicit subsidies, strengthen the minimum concessionality principle, take into better account policy distortions (particularly climate-related ones), and minimise free riding.	
Evaluate an adaptation of the portfolio approach, including options and implications related to moving towards an "originate-to-sell" model, assess implications for the income model and risk management as well as possible trade-offs with corporate goals, and review risk management regarding equity investments.	
Review organisational structures and staff incentives, including compensation, awards, performance assessment, and career progression.	
Regulators in developed countries should review their policies that limit pension fund and insurance company investments to A-rated, liquid bonds.	Governments of developing countries should raise this issue with their respective regulators.

With regard to MDBs, one option would be to reward reform implementation progress with shareholder support. This could take the form of results-based financing, where financial support is provided on the basis of positive reviews.

The SDGs are not on track, and the global transition to decarbonisation is moving too slowly. We have seen repeated calls for increased contributions from the private sector, and on a positive note the President of the World Bank has established the Private Sector Investment Lab. We await the full results of this initiative, and hope that PCC will indeed rise from the billions of dollars to trillions. Ultimately, this article intends to contribute to the ongoing discussion on the next steps that shareholders should take with regard to the management of development banks.

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