

POLICY PAPER

Strengthening development finance in fragile contexts

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Pioneering firms have the potential to achieve significant social and economic benefits in fragile and conflict-affected settings. However, these contexts involve higher risks and costs, which dissuades pioneers and investors. We argue that the public good these firms provide warrants the use of public funds to offset the costs of pioneering in these settings.

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Strengthening development finance in fragile contexts

Executive summary

Globally, the last few decades have seen significant progress in poverty reduction – but fragile and conflict-affected settings have been more difficult to reach, resulting in a growing portion of the world's poor living in these environments. Today, some 76.5% of those living in extreme poverty are located in fragile states, countries where almost one-quarter of the world's population live (OECD 2020).

Job creation and private sector growth are key requirements for poverty reduction and socio-economic development and, alongside necessary gains in social and political stability, are needed to create the conditions for countries to move out of fragility.

However, weaknesses in local economic conditions and legacies of poor governance, such as inadequate infrastructure or unpredictable regulatory frameworks, impose major barriers to private sector growth in fragile contexts. Investment opportunities are extremely limited and firms operating in these settings face considerable risks and disproportionately high costs.

To overcome the low-development, low-financing equilibria of these economies and to kickstart structural transformation, **pioneering investments** are needed. Pioneering firms are market movers and creators: they venture new markets, initiate new products and processes, and generate spillovers that reduce the costs and risks that subsequent market entrants face. A small number of investments may even have catalytic potential, enabling direct and indirect multipliers that ripple through the entire economy – igniting knowledge transfer,

capacity building, reducing the price of intermediate inputs, and establishing forward and backward linkages.

However, first movers face **high pioneering costs**: overhead and start-up costs, such as costs associated with establishing necessary infrastructure or utility connections, paying for security, and navigating unclear or incomplete laws and regulations. They frequently have to provide support to governments to strengthen the regulatory framework governing the sector of investment. With the smaller ticket sizes that are possible in fragile settings, these disproportionately high costs easily sink otherwise viable projects and there is a high failure rate of early-stage firms in these settings. This **first mover disadvantage** leads to persistent underinvestment in fragile contexts.

Pioneering firms cannot do it alone in fragile contexts – nor should they be expected to. Their contribution to strengthening enabling environments, establishing and developing new markets, creating jobs and income-generating opportunities, and catalysing private sector development in some of the world's most challenging environments is a

public good that warrants the use of public funding to offset the unique costs of pioneering in these settings.

Past approaches to private sector development in fragile states have not yielded significant progress to date, necessitating that development finance actors come together to collaboratively develop, test, and improve financing mechanisms that work to support pioneering firms in these difficult environments. Without compensation and reward mechanisms that account for the significant social and economic benefits and broader public goods that pioneers generate, these firms have few incentives to break new ground.

A financial niche exists for **development finance** in these contexts. Unlike traditional commercial lenders, development finance can often pool together large financing players and operate under an explicit development mandate, including to target private sector development in low-income and fragile environments. Development finance is also more tolerant to higher risks and can provide capital to firms on terms more favourable than commercial loans.

Development finance institutions (DFI) have a particularly important role to play in this work, leveraging their capacity to use public funding to de-risk investments, their ability to coordinate efforts across development finance actors, and their deep expertise, networks, and influence to mobilise collaborative approaches to both upstream work and project co-investment. The dearth of large firms in which to invest in fragile contexts also raises the question of a potential DFI role in helping to establish and grow local formal firms in these settings. Not all DFIs are set up to take on these roles and some adjustments in the way DFIs operate will be necessary

for them to be fit for purpose for the critical role they could play in fragile settings.

Working with **governments** of fragile states, as well as with **non-governmental organisations and civil society** in these countries, is vital to ensure that projects have buy-in from government and that local entities can provide the oversight and guidance needed to guard against the potentially negative impacts that business activities and private sector development may have in fragile, conflict-affected, and post-conflict settings. Additionally, careful regulation, context-specific strategies, and comprehensive approaches to conflict sensitivity are needed to ensure that private sector development can be a force for good.

Investing in **local intermediaries** – local banks for debt and venture capital funds for equity – and helping establish and strengthen the capabilities of these intermediaries is needed if DFI funding is to reach the numerous small and medium-sized enterprises (SMEs) operating in fragile contexts. Finally, there are a number of **innovative financing tools** that development finance actors can tailor for the realities of fragile settings, test, iterate, and scale up to achieve greater reach.

Job creation and private sector development have the potential to generate significant social and economic benefits in fragile and conflict-affected settings. If harnessed effectively as a force for peace and stability, catalysing private sector development in fragile contexts can be an invaluable public good that helps to stabilise fragile settings and improve the lives of the many millions of people who live in these places.

1 Introduction

Despite steady gains in global poverty reduction over the last few decades, there is a growing portion of the world's poor living in fragile and conflict-affected situations. Some 76.5% of those living in extreme poverty are located in fragile states, countries where almost one-quarter of the world's population live.¹

Fragile environments differ considerably from one another, but tend to share some common features, including “the lack of basic security, inadequate government capacity, the absence of a properly functioning private sector, and the presence of divided societies.”² These common symptoms are, however, the result of varying underlying drivers and historical factors that necessitate different policy responses. Without active support from the public and private sectors, fragile settings are likely to remain stuck in consistent cycles of poverty and under-development.

Breaking out of fragility requires reaching a **political settlement** that can support social cohesion and state building. Attaining a degree of political stability is an essential foundation for economic activity which, in turn, has the potential to create conditions conducive to supporting peace and escaping fragility.

For much of the developed world, the long-term transition toward prosperity has been rooted in **structural transformation** of the economy – the process by which production shifts from low- to higher-productivity activities both within and across sectors.³ As a modern private sector develops, a number of opportunities emerge over time. This includes higher-quality jobs, which alleviates poverty; increased tax revenues, which strengthens state capacity; and expansion into larger markets, which drives increases in firm productivity and growth.

A key obstacle for fragile contexts, however, is that weaknesses in local economic conditions and legacies of poor governance, such as inadequate infrastructure or unpredictable regulatory frameworks, impose major barriers to private sector growth. In addition, access to finance, which could help overcome some of these barriers, is typically constrained, preventing firms from realising their potential. Escaping this low-development, low-financing trap requires **pioneering investments**, which play a key role in kickstarting the process of structural change.

Pioneering investments are **market movers and creators**: they initiate new products and processes that can be replicated and scaled, generate spillovers which may offer wider public goods for society, and reduce the costs and risks associated with subsequent investments. Pioneering investments are often made by multinationals, which may be better placed to overcome some of the distortions of fragile contexts by bringing with them production knowledge, connections to foreign markets, and deeper capital resources.⁴

Firms entering fragile contexts face disproportionately **high pioneering costs**: overhead and start-up costs associated with establishing necessary infrastructure or utility connections, paying for security, and navigating laws and regulations.

76.5%

Of those living in extreme poverty across the world, 76.5% are located in fragile states, countries where almost one-quarter of the world's population live

1 OECD 2020.

2 Commission on State Fragility, Growth and Development, 2018, p. 4.

3 Rosenstein-Rodan 1943, Nurkse 1953, Lewis 1954, Rostow 1960.

4 Jones 2011.

They must also navigate the deals that shape firms' policy treatment in contexts where variability in policy implementation is common.⁵ Additionally, projects in fragile contexts tend to be relatively small. As such, high overheads and start-up costs can represent such a large portion of investment costs that they sink otherwise viable projects. High uncertainty in these settings, due to political and economic instability or a lack of information on comparable firms' experiences, also concerns investors, whose ambiguity aversion contributes to underinvestment in these settings.

Developing serious investment opportunities in fragile settings is a complex task which requires time, resources, and deep local knowledge. Given poor starting conditions, reform efforts need to be envisioned as a process of facilitating market *creation* before one of market *development*. Basic enabling factors must be strengthened to attract and support formal firms, such as improved regulatory frameworks, a skilled labour force, and enforcement of quality standards. These improvements could reduce the overall risks for both pioneers and subsequent market entrants.

But this is not an easy task. It involves fixing a number of weak links in the markets of fragile countries and *all* links may need to be fixed for the chain to be strengthened.⁶ Addressing these weak links is nonetheless vital and could have transformative impact on economies.

Private sector development and job creation in fragile contexts is frequently considered to be a **public good**, a key element in achieving and maintaining peace and, as such, the use of public resources for this purpose can be easily justified. However, the positive impacts of private sector development are not a given. In fragile and conflict-affected settings, private sector activities just as often have negative impacts by contributing to the continuation of conflict, such as through firms that benefit from and perpetuate the conflict economy or job creation that entrenches ethnic or regional inequalities.⁷ Where the distribution of benefits from economic growth remain skewed and contested, additional resources will fuel, rather than bridge, societal divides.⁸

These risks necessitate that private sector development interventions in fragile, conflict-affected, and post-conflict contexts be approached with considerable nuance and **context-specific strategies**.⁹ Regulation of the private sector to guard against deepening tensions, monitoring the distribution of benefits from private sector development, and engaging with civil society to remain informed of changing social and political dynamics are all critical.

Undoubtedly, financing private sector growth in these settings is not straightforward and requires leveraging finance across both the public and private sectors. Many donors have already adopted blended finance models and large private investors are paying greater attention to impact-led approaches. Addressing the challenges of firm growth in fragile contexts will need **collaboration, innovation, and shared purpose** across multiple players, with development finance institutions (DFIs) potentially playing a particularly important coordination role.

⁵ Pritchett & Hallward-Driemeier 2010.

⁶ Jones 2011.

⁷ Mayer et al. 2020, Venugopal 2012.

⁸ Ganson & M'cleod 2018.

⁹ Mayer et al 2020.

2 Structural change and escaping fragility

2.1 Structural change, productivity, and development

Escaping fragility requires gains in both political and economic stability. On the economic side, increased firm growth and productivity is needed for fragile environments to become more stable, prosperous, and liveable. Structural transformation *across* sectors, even more so than *within* sectors, has driven some of the most impressive escapes from poverty in history.¹⁰

Structural change is the process by which factors of production – land, labour, and capital – shift from lower to higher productivity activities. In contexts of early-stage development, this is typically seen by countries shifting from rural agriculture and informal services towards growth driven by industrial and knowledge sectors in cities.¹¹ In China, for example, the transition from poverty to rapid social and economic progress after the late 1970s was largely driven by reforms that shifted labour from subsistence farming into urban manufacturing.¹²

As economies undergo structural change, large and specialised **formal firms** are able to develop and, in turn, generate outcomes that have the potential to support stability:

- **Productive jobs** – Underemployment and unproductive jobs are replaced with more productive, higher-wage opportunities in the formal private sector. As household incomes increase, so do their investments in productive assets such as health, nutrition, and education. Job creation also increases the opportunity cost of conflict and, hence, strengthens incentives for social cohesion and stability.¹³
- **Supporting infrastructure** – Private investments to support industry growth have spillover effects on the wider economy. These include the development of critical infrastructure – such as roads, power generators, and equipment – as well as ancillary institutions and services, including finance, insurance, and legal services.
- **Exports** – Excluding natural resources, fragile contexts tend to have a very limited export base, which severely constrains firm growth and foreign exchange earnings. Exporting connects the private sector with larger external markets, providing an important source of firm-level growth, productivity increases, job creation, knowledge generation, and product upgrading.
- **Public revenue** – More formal firms and increased revenue from exports broadens the tax base and provides a critical source of tax revenue for otherwise resource-constrained governments. This strengthens governments' ability to deliver public goods and services, including investing in performance-enhancing infrastructure with the potential to ignite further private sector development.

¹⁰ McMillan & Rodrik 2013.

¹¹ Lewis 1954, Caselli 2005, Kuznets 1966, Herrendorf et al. 2014.

¹² Kriticos & Henderson 2019.

¹³ Collier et al. 2019, IFC 2019.

While these outcomes are attainable, they do not happen automatically. First, active public policy is needed to create an **enabling environment** in which the private sector can thrive.¹⁴ Investments in land and infrastructure are particularly important for formal firms to gain the scale and specialisation efficiencies of cities, for instance.¹⁵ Similarly, institutional investments that enhance the rule of law, for example, are necessary to reduce the risk of expropriation and safeguard large-scale investments.

Second, while these public policies are critical for creating an enabling environment for private sector development, the process of structural change itself is largely **private sector-driven**.¹⁶ Private firms tend to have the competitive incentives needed to progressively improve efficiencies and productivity, thereby creating more higher productivity jobs. However, in some instances, such as in Rwanda, the state has demonstrated an important role in furthering structural change through harnessing the rents of early capital development for deployment in longer-term development.¹⁷

Third, in fragile and post-conflict settings, whether these outcomes result in social cohesion and stability depends centrally on **how benefits are distributed** within the population. In these contexts, job creation frequently favours some groups over others, giving rise to ethnic and regional inequalities that are conflict-inducing.¹⁸ How governments use tax revenue collected from the private sector is also critical – if revenues are not used to fund inclusive public services, tensions can be aggravated.

The process of structural transformation that produced the socio-economic progress of the last two centuries has been highly global. China and other countries in South East Asia have thrived by entering global export markets and capitalising on wide wage gaps in the manufacturing sector, making them more competitive than high-income countries. The same process, however, has been rarer in fragile settings. In large part, this is due to fragile countries being at earlier stages of state and nation building, less economically developed, and less integrated into the global economy.

Without productivity growth and structural change, many fragile contexts have become stuck in low development equilibria with stagnating or falling growth rates. Not only have fragile settings fallen behind, but their divergence from the rest of the world is *growing* – due to capital flight and low rates of private investment, for example – making it more difficult for them to be internationally competitive and to enter saturated export markets.¹⁹

¹⁴ Noman & Stiglitz 2015.

¹⁵ Collier 2016. It should be noted, however, that investments in land and infrastructure are the riskiest investments to make in fragile contexts, given their immovable nature, with investments in firms with fewer assets or more mobile assets being preferred in fragile settings.

¹⁶ Noman & Stiglitz 2015.

¹⁷ Booth & Golooba-Mutebi 2011.

¹⁸ Venugopal 2012.

¹⁹ Collier 2007.

“In contexts of fragility, pioneering firms are a critical element in economic transformation.”



Photo credit: Jonathan Ernst/World Bank

2.2 Pioneering investments and structural change

Pivotal change is difficult to achieve in fragile and conflict-affected settings. The average firm in fragile contexts is small in size and local in scope. The informal economy accounts for roughly 86% of employment in Africa (72% if agriculture is excluded).²⁰ In Dar es Salaam, Tanzania, the average firm consists of just one person, reflecting the difficulties of growing a business in challenging environments. Breaking out of this low-productivity equilibrium requires a transformative shock, such as that offered by pioneering investments, particularly those with strong **catalytic potential**.²¹

Pioneers' operations aim at commercialising new products and processes and venturing previously under-explored markets, engaging in a process of market creation and expansion.²² Pioneering firms vary in age, sector, and origin, but tend to be larger, have additional experience, rely less on fixed assets, and are able to innovate at smaller sizes.²³ Given the scarcity of foreign firms in fragile settings, the majority of pioneering firms in these contexts are domestic (although, where they do exist, foreign firms are significantly more likely to pioneer relative to domestic firms).²⁴ Firms from other countries in the region may enjoy a special advantage due to their contextual knowledge and pre-established linkages with regional markets.

In contexts of fragility, pioneering firms are a critical element in economic transformation: by supporting improvements in the business environment and facilitating greater market knowledge, they enable more firms to enter the market while also supporting existing firms through backward and forward linkages. They have the potential to act as development catalysts for entire markets by reducing entry barriers.

Key benefits of pioneering firms include:

- **Knowledge production** – With limited information, investors are unable to adequately evaluate and quantify the potential risks and rewards of investing in fragile contexts, and ambiguity aversion means their default choice is often not to invest. Pioneering firms, however, generate information about the markets they enter, which provides information that was previously either missing or unreliable, thereby reducing uncertainty.
- **Investment spillovers** – Pioneers make essential investments which lead to direct and indirect productivity gains for existing firms in the country, as well as for successive firms entering that market. These include investments such as training labour, establishing consumer markets and supply chains, and supporting public authorities to develop legal and regulatory frameworks. Once undertaken, these investments reduce overhead and start-up costs for successive market entrants who can leverage gains from actions taken by pioneers.

²⁰ ILO 2018.

²¹ Collier et al 2019.

²² IFC 2019.

²³ Collier et al 2019.

²⁴ Ibid.

2.3 The economic case for supporting pioneers

While pioneers serve the public good, their pioneering involves taking on notable risk and costs. The cost of upstream activities needed to make projects possible places a disproportionately high burden on individual pioneering investments, sinking otherwise viable projects. Moreover, the stakes are unfavourable for pioneers: if a project fails, they are often left with no more than a financial loss, despite making valuable contributions that are often beneficial to the wider market. If the pioneer succeeds, successive market entrants will be attracted by the opportunities that the pioneer has uncovered and are able to enter the market without having to bear the same risks and costs. Either way, the pioneering firm is disadvantaged, and these disadvantages generally outweigh the benefits offered by low or no competition in the short run.

This **first-mover disadvantage** leads to persistent underinvestment in fragile contexts. Without compensation and reward mechanisms that account for the significant social and economic benefits and broader public goods that pioneers generate by supporting the creation of new markets, firms will have few incentives to break new ground.

An illustrative case is that of Southern Sudan Beverages Ltd, a pioneering investment in South Sudan (see Box 1). The market failure that the first-mover disadvantage raises motivates the need for supportive investments that offset the additional costs that pioneers incur and reward them for undertaking activities that have a positive impact on the wider economic environment.

Table 1: Advantages and disadvantages of pioneering in a fragile setting

First-mover advantages
- Priority access to natural resources, land, and labour
- Limited initial competition
- Provision of missing service and possibility to capture large demand
- Potential for brand recognition and customer loyalty that persists after subsequent entrants reach the market
- Access to government authorities and stronger negotiating power
First-mover disadvantages
- Poor knowledge about local market conditions
- Necessary trial and error phase
- High (often unobservable) start-up costs, such as navigating the regulatory environment, training labour, establishing and training suppliers, developing infrastructure, etc.
- Inertia of local firms
- Shifts in demand, supply, and regulatory requirements
- Risk of failure due to unprofitability, conflict, change in political leadership, etc., with little or no cost recovery options
- Free-riding and imitation from subsequent market entrants
Socio-economic benefits to society
- Labour training and capacity building
- Provision of missing goods and services
- Investment in public infrastructure
- Regulatory framework development
- Job creation
- Knowledge production, contributing to lower perceived risk
- Stimulus to domestic firm ecosystem through the establishment of backward and forward linkages with suppliers and distributors
- Signalling effect and attraction of subsequent market entrants, which sustains and scales socio-economic effects

Box 1: Southern Sudan Beverages Ltd and the challenges of pioneering in fragile settings²⁵

Following the signing of the 2005 Comprehensive Peace Agreement, Southern Sudan was granted six years of autonomy from the Sudanese government leading up to the 2011 referendum, which culminated in South Sudan's independence. Taking advantage of the fact that the region was no longer governed by Sudan's Islamic law, which prohibited production and sale of alcohol, SABMiller, a South African brewery and beverage multinational, established a subsidiary, Southern Sudan Beverages Ltd (SSBL), in Juba in 2009. It was country's the first multinational manufacturer.

The high-risk investment decision was motivated by the opportunity for SSBL to capture a large and unserved local demand, primarily for alcoholic beverages, before competitors entered the market. SABMiller already had investments in several other challenging contexts in sub-Saharan Africa and was optimistic that the success of a similar venture in neighbouring Uganda could be replicated. Southern Sudan's Minister of Foreign Affairs was supportive of the investment, which SABMiller hoped would be a positive signalling effect for other firms and would encourage development of the local non-oil economy.

The investment realised notable positive social and economic impacts, employing over 400 Southern Sudanese nationals, establishing a network of 50,000 retailers, and generating US\$ 1 million in tax receipts. SSBL became the largest employer and tax contributor outside of the oil sector. However, the company also faced severe challenges, including:

- **Lack of financing:** Due to the underdeveloped banking sector, SSBL could not obtain any financial support domestically. It relied on credit from the IFC and SABMiller, its parent company, which became its only lender from 2015 onwards.
- **Lack of domestic inputs:** Weak local agricultural and industrial development forced SSBL to source most of its inputs from foreign markets, limiting its ability to foster local partnerships and raising its input costs. There were also no incentives in place to use local inputs, which were notably more expensive.
- **High costs:** Transport costs were twice as high as the regional average due to the lack of paved roads, and the limited electricity network forced SSBL to rely on costly diesel generators for electricity generation. Corruption, coupled with an ineffective judicial system, further raised costs and lowered the firm's profitability. SSBL's operational costs were one-third higher than SABMiller's comparable investment in Uganda.
- **Macroeconomic challenges:** In 2015, high government spending fuelled a growing budget deficit. Authorities responded by printing money, which led to soaring inflation and currency depreciation. Foreign currency, needed to finance SSBL's imported inputs, became increasingly difficult to source.

In early 2016, SSBL announced its decision to close operations in South Sudan, identifying the shortage of foreign currency as a critical factor in the closure decision.

²⁵ Morjaria & Haas 2017, Manson 2015, Jones 2015, Kuo 2016, Jones 2016.

3 Supporting pioneering investments through development finance

The social and economic benefits that pioneers can potentially generate in fragile contexts are significant, but the defining characteristics of these settings dissuade conventional providers of finance for the private sector. The public good nature of private sector development does, however, make a strong case for intervention in the form of financial support that compensates pioneers for incurring the risks and costs associated with entering and operating in challenging environments.

The financial capacity of **national governments** is often too low to support subsidising private sector investments, due to a combination of weak domestic revenue mobilisation, high debt repayment burdens, limited ability to raise international credit, and issues of corruption and abuse of power. In addition, instability and political crises limit governments' abilities to sustain long-term investment strategies.

Traditional **commercial lenders**, such as banks, private equity firms, and pension funds, tend to have specific return expectations, time horizons, and risk appetites that can rarely be met by the investments possible in fragile settings. This limits commercial lending in these contexts. Additionally, their traditional skill sets – based in modelling, valuation, selection, and structuring – falls short of the know-how needed to invest in fragile environments, where conflict sensitivity and the technical expertise needed to support governments to develop legal and regulatory frameworks are also needed.

This leaves a ‘financial niche’ for **development finance actors**, which include multilateral development banks (MDBs), DFIs, bilateral lenders, and philanthropic organisations. Unlike traditional commercial lenders, development financing can often pool together large financing players and operate under an explicit development mandate, including to specifically target private sector development in low-income and fragile environments. Development finance is also more able to tolerate higher risks and to provide capital to private firms on terms more favourable than commercial loans.

Table 2: Investment requirements in fragile contexts

Characteristic	State	Commercial institutions	Development finance
Financial resources	x	✓	✓
Patient and/or risk-taking capital	x	x	✓
Development mandate	✓	x	✓
Decision-making without political influence	x	x / ✓	✓

3.1 The current state of development finance in fragile settings

Traditionally, the development finance space was dominated by bilateral and multilateral aid, which was primarily funnelled to the public sector in areas of capacity building, regulatory reform, macroeconomic management, and humanitarian assistance. The financing requirements of the Sustainable Development Goals (SDGs), estimated in trillions of US dollars, have made clear that overseas development

assistance (ODA) alone cannot achieve such a vision. New sources of financing need to be mobilised to scale up investment from billions to trillions.

Development finance has undergone a significant transformation in developing countries, with a rise in foreign direct investment (FDI) inflows and growth in DFI finance, alongside comparative stagnation or reduction of ODA. However, the situation in fragile settings is very different:

- **ODA** has increased by 26% in real terms between 2009 and 2016 in fragile contexts, which receive nearly two-thirds of global funds. ODA is, and will continue to be, a critical source of financing for governments in conflict and fragile settings, rivalled only by remittances in terms of size, and 2.3 times greater than the value of FDI inflows into these settings.²⁶ Not all ODA is intended for longer-term development purposes – some 25% is allocated for humanitarian needs.²⁷
- **FDI inflows** into fragile states have been increasing steadily over the last two decades. However, they still represent a small drop (about 1%) of global FDI flows, are primarily captured by a few middle-income and resource-rich countries, and trends in investment and disinvestment vary significantly with context.²⁸ FDI as a share of GDP in fragile countries is three times higher in resource-rich countries than in non-resource-rich fragile states.²⁹
- **DFIs**, both private sector windows of MDBs and bilateral investment agencies, have experienced significant growth in their portfolios since the 2000s. Nonetheless, their track record in fragile contexts has received criticism: they have been accused of adopting risk-averse investment strategies and transactional approaches to investment deals, prioritising financial returns over development impact, and making limited proactive efforts to seek out new opportunities.³⁰ These dynamics have led DFI investment to focus on upper-middle income markets and safer sectors, as well as frequently favouring debt over equity, potentially limiting investment additionality.³¹

The above highlights the need to restructure the development finance architecture in ways that can enhance coordination and synergies, maximise development finance impact, and catalyse private sector investment in fragile contexts.³²

Given the complexities and risks of supporting pioneering investments in fragile settings and the diverse expertise and mandates of development finance actors, significant value will come through development finance players operating in a cohesive and coordinated manner, under a common strategy, and pursuing shared objectives. So far, this has not always been the case as, at times, their actions remain fragmented and in competition with one another.

²⁶ ODA grows to 11.5 times the value of FDI inflows and more than twice the value of remittances in extremely fragile contexts, according to OECD 2020.

²⁷ OECD 2020, OECD 2018.

²⁸ Ragoussis & Shams 2017, OECD 2020.

²⁹ Jensen 2020.

³⁰ Attridge et al. 2019, Cusack et al. 2020.

³¹ Attridge & Engen 2019, Kenny 2019, Lee & Sami 2019.

³² Savoy et al. 2016.

3.2 The key role of DFIs

Certain actors will need to take a lead in shaping this changed mode of working. DFIs have been increasingly identified as the player that could increase collaboration between development finance actors. DFIs' potential comparative advantage in leading private sector transformation in fragile settings hinges on the following elements:

- An explicit **private sector development focus**, as opposed to the more humanitarian or public sector aims of non-governmental organisations (NGOs) and MDBs.
- **Sizeable and growing balance sheets**, reflecting shareholders' vision for a greater role for DFIs in the global development agenda.
- **Capacity to invest and lend on favourable terms** as they are able to take on higher risk and accept lower rates of return on public funds, justified by the significant social and economic benefits their investments have the potential to generate. The use of blended finance further expands DFIs' risk-bearing capacity through crowding in private capital.
- **Deep expertise, networks, and influence** across public policy and private investment, and the ability to mobilise joint approaches.

Shareholders have also been vocal about DFIs assuming greater risks and maximising development impact.³³ This is exemplified by the recent creation of the US\$2.5 billion Private Sector Window by IFC and the Multilateral Investment Guarantee Agency (MIGA) to mobilise private sector investment in International Development Association (IDA) countries, with a special focus on fragile and conflict-affected states.³⁴

One of the greatest constraints to DFI investing in fragile contexts to date is a **lack of competent, clean sponsors** to manage firms and investments, as well as projects that do not pose reputational risks. DFIs have strict Integrity Due Diligence (IDD) rules governing who they can invest with, prohibiting transactions with those who are politically connected or have been involved in prior illegal activity – a particularly challenging threshold for fragile, conflict, and post-conflict settings. Supporting the establishment of new, large firms with the competence and clean track record needed to pass IDD muster will be an essential part of DFI work in fragile contexts.

Similarly, ensuring that products are traceable and that there is no forced or child labour in the supply chain is essential, yet challenging, in undeveloped contexts. Additionally, the sometimes harsh scrutiny and negative media coverage that can be received from Non-governmental organisations (NGOs) and civil society organisations can lower DFI shareholders' willingness to take on difficult investments in fragile environments.

To take on the leadership and coordinating role of championing pioneering investments in fragile contexts, DFIs will need to draw on their investment

³³ Ibid.

³⁴ IDA 2016. IDA is the part of the World Bank that helps the world's poorest countries by providing zero or low-interest loans or grants for programmes that support economic development and poverty and inequality reduction.

management expertise. Additionally, by better understanding the types of investment that can bring transformational impact in these settings and modifying their corporate incentives accordingly, DFIs can pivot their investment approach and facilitate a process of change across development finance stakeholders as a whole.

3.3 The types of investment that are most needed

Some types of investments offer particular value in fragile contexts. While it is generally not possible to meet all criteria, and some aspects may be in conflict with one another, certain core principles could usefully guide investment decision-making.

3.3.1 Focus on jobs, not deals

Fragile settings are desperately short of productive jobs in the formal sector. This keeps firms from achieving economies of scale and specialisation and hampers countries from making progress towards structural transformation and escaping fragility.

As providers of capital, DFIs are primarily suited to making capital-intensive rather than labour-intensive investments. However, there is still considerable scope for them to have a tangible impact on job creation. Indeed, development finance investments should be assessed based on their potential to generate decent, formal jobs that move people out of precarious, informal work – their value is even greater if they can catalyse job creation beyond the boundaries of a single deal. As such, job creation should be used as a metric of success that is measured and rewarded within DFIs, instead of defining success primarily in terms of number and size of individual deals.

Understanding who benefits and who loses out from job creation is central to assessing the development impact of investments.³⁵ Job creation that benefits those who would otherwise remain in poverty, particularly members of marginalised groups, and that achieves fair distribution of benefits along ethnic and regional lines has the greatest impact on development and stability.³⁶ Beyond creating decent, formal sector jobs, investments that improve the quality of informal sector jobs are also critical.³⁷

3.3.2 Raise productivity

Efforts to reduce poverty and raise standards of living require higher real wages, which is the outcome of more productive economies – however, investments that raise productivity may reduce labour requirements, leading less productive firms to shed jobs.³⁸ How to weigh investments that create many, low-skilled jobs against those that significantly raise productivity but create fewer, higher-paying jobs is not straightforward. Furthermore, the spillover effects of these different investments

³⁵ Carter & Sedlacek 2019.

³⁶ Ibid., Mayer et al. 2020.

³⁷ Carter & Sedlacek 2019.

³⁸ Ibid.

on the broader economy cannot always be gauged easily. That said, productivity increases are essential for structural transformation and higher wages and investments that contribute to this should be recognised.

3.3.3 Investments with transformative potential

Catalytic investments are those that affect multiple ‘nodes’ of an economic network. They enable direct and indirect multipliers that ripple through the entire economy. As a consequence, the whole system re-arranges itself and thrives through imitation, knowledge transfer, capacity building, reduction in the price of intermediate inputs, and establishment of forward and backward linkages. A transformative investment improves the returns of subsequent investments and reduces intermediate costs of production.³⁹

A critical feature of catalytic investments is that, rather than being an end in themselves, they enable the creation of clusters and webs of production through which economies of specialisation and agglomeration can be realised.⁴⁰ Examples include investments in the transportation sector that reduce transportation costs across the economy, energy investments that unlock inclusive energy access, or the knowledge seeding that revolutionised the Bangladeshi garment industry (see Box 2).

Box 2: Catalysing an industry through pioneer seeding in the Bangladeshi garment sector⁴¹

In the aftermath of its independence war of 1971, Bangladesh suffered from several symptoms of state fragility, including weak institutions, rife corruption, an underdeveloped private sector, poor enforcement of property rights, and widespread illiteracy.

Bangladesh’s development has been primarily driven by the growth of the garment industry, which represents the principal source of foreign currency earnings and employment for the country. But this was not always the case: traditionally, the sector had comprised a handful of firms utilising rudimentary, low-tech production techniques and struggling with low productivity, profits, and exports.

The industry was enabled by what has been referred to as the **knowledge seeding** of a domestic pioneering firm, Desh Garments, by a foreign multinational, Korea’s Daewoo, in 1978. As part of a partnership, Daewoo took 130 Desh workers to Korea and trained them on assembly line manufacturing – a key step to scale up production and enhance quality – in exchange for a share of export revenue. Upon the workers’ return, Desh became the single largest factory in Bangladesh.

³⁹ Carter 2019.

⁴⁰ Collier 2007.

⁴¹ Mostafa & Klepper 2018.

Over time, the development of the entire sector was galvanised through processes of imitation as well as transfer of tacit knowledge enabled by the mobility of former Desh workers, who were sought after and hired by a growing number of competitors. Broader contributing factors included favourable access to US and European markets, political support among senior Bangladeshi policymakers for industry growth, and the ability to make land available to support formation of production clusters in Dhaka and Chittagong.

Industry growth was exponential: the number of factories went from 300 in 1980 to over 4,500 today, and exports soared and captured US and European markets. This example demonstrated how an industry pioneer can play a key role in catalysing development of an entire economy, even in contexts where traditional growth conditions, such as strong institutions and high literacy rates, are missing.

Investments with catalytic potential are few and far between, but where they exist, they should be seized. Requiring transformative potential for all investments is, however, too high a standard for fragile contexts – rather, it is a boon when these opportunities emerge.

3.3.4 Financing should be flexible, patient, and risk tolerant

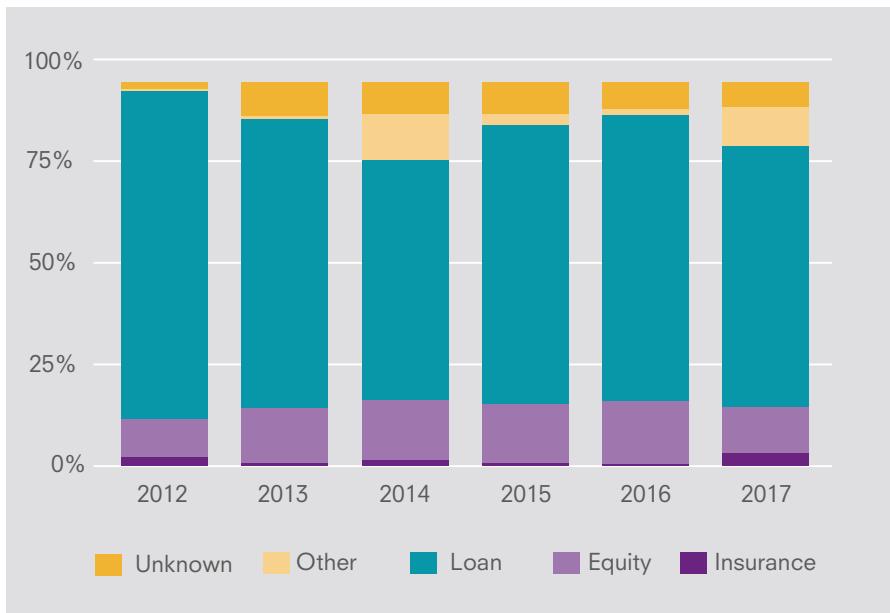
Conventional DFI financing models and tools tend to not be well suited for the needs of fragile settings. DFI ticket size requirements often approach US\$ 20–30 million, but it is unrealistic to insist on such large projects in fragile contexts, or for fragile economies to be capable of absorbing such large windfalls of finance. Viable opportunities in fragile contexts are found at lower thresholds, often below US\$ 5 million. Rather than prioritising large-scale investments, DFIs could enable smaller, steady, long-term investment flows which are capable of withstanding volatility.⁴² This could be most effectively operationalised by DFIs working through local intermediaries – an approach that could bring down overhead costs, build out domestic financial sectors, and leverage local intermediaries' superior contextual knowledge.

Investment strategies in fragile settings also need to allow for greater risk tolerance through increased equity participation, which may be particularly additional in fragile contexts where early-stage equity markets are severely underdeveloped. Despite this need, loans currently make up over 70% of DFI commitments globally, with peaks in excess of 90% in certain institutions. Equity, on the other hand, generally remains below 30% of portfolios and is concentrated in higher income, typically less fragile countries (see Figure 1).⁴³ The proportion of debt operations in fragile settings is likely much higher than the global average.

⁴² CDC Group 2019.

⁴³ Lee & Sami 2019, Kenny 2019. Notable exceptions include CDC Group and, to a lesser extent, DEG.

Figure 1: DFI investment portfolio by financial instrument (%)⁴⁴



Institutional risk aversion is one of the factors that drives an over-reliance on loans and quasi-loans because debt ensures greater certainty of returns and better protection of investors in the event of bankruptcy. Equity, on the other hand, carries greater reputational and financial risks since investors become legal shareholders of the firms. This can be problematic where local firms do not pass DFIs' IDD muster. Local firm owners may also resist equity investments – they may not want to dilute their shareholdings, be exposed to close scrutiny, or may be family-owned businesses not open to bringing in external shareholders.

Moreover, equity investments generally require an on-the-ground presence and deep local knowledge to be successful, which can increase overhead costs of these investments for DFIs. Additionally, the illiquidity of equity will, over time, also limit DFI capacity to make new investments as funds can be tied up in equity portfolios for many years, whereas debt liquidates over a shorter horizon and frees up funding for new investments. A balance between debt and equity is therefore needed, but equity is undoubtedly under-represented in DFI portfolios in fragile settings.

Although managing firms themselves in fragile contexts is not necessarily DFIs' value add, equity does carry a number of favourable characteristics in fragile settings that cannot be promoted by debt:

- **Risk absorption and stability** – Equity investments do not place immediate requirements on the company to generate returns and repay investors. This allows firms to take a longer-term approach to investment and pursue higher growth strategies. Equity investments also offer greater stability than debt to the firm since, during temporarily volatile times, shareholders can only “run” by selling their shares – a difficult task in fragile markets, especially during bad times.⁴⁵

⁴⁴ Center for Global Development 2020. The DFI Dashboard captures data for nine DFIs: DFC, CDC Group, DEG, FMO, Proparco, IFC, CDB, AIIB, and JBIC.

⁴⁵ Carter 2020.

- **Signalling effect and leverage** – DFIs assuming equity positions sends risk-reducing signals to potential investors, grounded in DFIs' reputation in areas of due diligence, project screening, and technical skills. In turn, strong positive signals can boost leverage ratios, catalyse new firms to the market, and improve development impact.
- **Comparative advantage** – MDBs' knowledge of countries' macroeconomic conditions, economic dynamics, and on-the-ground presence are critical in equity operations and may confer on some DFIs an important comparative advantage in this investment class compared to other actors.⁴⁶
- **Hands-on management** – Equity allows for better control of management decisions. This is especially relevant in fragile contexts where deals might require a more hands-on approach than in conventional settings. Theoretically, DFIs may therefore become involved in a diverse and unconventional range of activities, from business development to recruitment, maintenance, social infrastructure development, or regulatory reform.⁴⁷ Taking on such responsibilities, however, exposes DFIs to heightened operational and reputational risks in these challenging environments. DFIs are also not necessarily set up to handle this level of hands-on management, which, furthermore, constrains their capacity to support more investments.

3.3.5 Investment strategies should adopt conflict sensitive approaches

Although there is a growing interest in policy circles about the role that private investment could play in promoting peace and mitigating conflict, to date we lack conclusive empirical evidence on the causal relationship between business and peace. What is clear, however, is that business as usual in settings affected by fragility and conflict does not always yield peace-positive outcomes; indeed, it often fuels new grievances or exacerbates tensions.

The negative impact of private sector operations on fragility is often the result of large inflows of resources into highly resource-scarce environments, with local actors vying for control of these resources. In contexts characterised by weak institutions and high levels of corruption, tensions can result from corporate taxes and royalties paid by firms to the government being appropriated by elite groups or diverted towards other parts of the country instead of being used toward socio-economic investments that benefit local communities affected by investments. The lack of effective legal frameworks also deprives local communities of ways to obtain government protection from the negative impacts of business operations, such as pollution or forced resettlement. In some cases, firms may even benefit from the continuation of conflict and take deliberate actions that undermine peace.⁴⁸ A case in point is that of Sierra Leone, where businessmen were deeply implicated in the country's civil war, supporting opposing factions for personal gain.⁴⁹

In fragile contexts, it is vital that DFIs and others adopt conflict sensitive approaches that take into account the contextual and complex reality surrounding an investment,

⁴⁶ Lee & Sami 2019.

⁴⁷ CDC Group 2019.

⁴⁸ Mayer et al. 2020.

⁴⁹ Ganson & M'cleod 2018.



**“Conflict sensitivity
is key to DFIs’ dual
mandate of furthering
private sector
development and social
and economic gains.”**

Photo credit: Asanka Brendon Ratnayake

as well as the interactions that the investment has with the wider environment. Conflict sensitivity also involves adopting measures that proactively mitigate against negative impacts caused by private sector activity and that promote peace efforts.

In their conflict sensitivity approaches, DFIs should steer away from one-size-fits-all, magic bullet thinking, and instead recognise the complexities of the issues at hand. Strategies should be tailored to the type and size of businesses, as the sector and scale of operation have different implications for local dynamics. For example, a mining investment can result in environmental destruction that impacts local communities and fuels anger, triggering greater tensions than establishing manufacturing operations may.⁵⁰

DFI conflict sensitive strategies should also involve:

- **An explicit recognition that private sector investments inevitably interact with complex, political dynamics** and that DFIs bear the responsibility of carefully designing and managing projects, particularly those that have the potential to trigger or worsen tensions and conflicts.
- Strategies that account for the **evolving nature of the conflict cycle**, recognising that an investment project might not be successful in some conflict stages, but at other times may support political transitions through mitigating tensions and promoting stability.
- **Sector and project-specific analyses**, such as fragility assessments and political economy analyses, detailing the potential risks and impacts an investment poses to fragility and conflict, and offering recommendations on how to address these dynamics.
- **Intentional, pre-determined interventions** to manage DFI impacts on fragility and conflict. For instance, infrastructure projects would need to include consultations with affected communities and appropriate resettlement plans, if relevant. The potential for investment projects to exacerbate existing ethnic and regional inequalities should be borne in mind and, to the extent feasible, attempts made to spatially distribute investments.
- Development and adoption of **conflict sensitivity metrics** to track impacts throughout the investment cycle. Metrics could aim to capture information on aspects such as the degree of societal agreement with the use of land and natural resources, the effectiveness of conflict prevention efforts, and the extent of positive impact on the informal sector.⁵¹ These aspects are, however, not easy to capture and investees would need to be supported in this exercise.
- Since conflict sensitivity is a relatively new area of practice for DFIs, **inter-institutional collaboration** should be prioritised, with an emphasis on lesson sharing, joint piloting, and standardisation of requirements and practices. Recent evidence suggests that peace-positive impacts are more likely when investments involve partnerships with other firms and stakeholders, including civil society and government agencies.⁵²

⁵⁰ Mayer et al. 2020.

⁵¹ Ganson & M'cleod 2018.

⁵² Mayer et al. 2020.

Conflict resilience is also frequently a factor in DFI decision-making – for example, it's less risky to invest in firms that are able to continue functioning during upticks in conflict, such as firms in the services sector.

While DFIs are yet to fully and formally operationalise these principles, recent initiatives by the European Investment Bank and the IFC seem promising in this regard (see Box 3).

Box 3. Conflict sensitivity initiatives by DFIs⁵³

The **European Investment Bank (EIB)** developed **conflict-sensitive guidelines** for projects in fragile settings in 2015. In 2017, it launched the Conflict Sensitivity Helpdesk to provide staff in headquarters and country offices with project-specific support on due diligence mechanisms and conflict sensitive approaches throughout the conflict cycle.

IFC's Conflict-Affected States in Africa (CASA) programme has been adopting a **fragility lens** in its advisory services to early-stage projects since 2015. This approach is based on an assessment of the political risks associated with an investment and careful analysis of the fragility-inducing impacts that it could provoke. The fragility lens is operationalised by ensuring that at each stage of the project cycle the following questions must be addressed:

- What is the conflict context in which the project operates?
- What is the two-way interaction between the project and its context?
- What are the best ways for the project to minimise its negative effects on conflict and maximise its positive impacts?

3.3.7 Additionality should underpin investment decisions

Development finance investments in fragile settings and elsewhere should not substitute or displace private finance. Such an approach would run against DFI aims to mitigate market failures, support the development of private sector ecosystems, promote competition, and crowd-in private capital. Rather, development finance investments should be **additional**: they should enable and facilitate investments which would not have gone ahead had there not been such external, non-commercial support.

Financial additionality, which involves providing finance at more favourable terms than what the market is able to provide, is not always considered sufficient to justify DFI intervention as it could generate market distortions through the provision of excessive and unfair subsidies to investees without any assurance of development

⁵³ IFC 2018a.

impacts.⁵⁴ Factoring in **development additionality** is a useful consideration.⁵⁵ This aims to ensure that DFI support is conditional upon investee firms realising desirable social and economic impacts that commercial financiers are often not motivated to pursue.

While DFIs may be required to prove additionality, the lack of real-world counterfactuals may make this assessment difficult.⁵⁶ Demonstrating additionality, or at least improving the odds of additionality, could be done by analysing the circumstantial evidence of local market conditions that are more likely to manifest in the presence of an additional investment.⁵⁷

In any event, given such low levels of investment in most fragile contexts, the majority of DFI investments would easily demonstrate both financial and development additionality, reinforcing the case for DFIs to focus on fragile settings rather than more developed economies.

3.4 The challenges DFIs face in fragile settings

Despite there being an important role for DFIs in fragile contexts, they still face significant barriers to operating and investing in these settings or assuming a coordinating role within the development finance arena.

3.4.1 Contextual challenges

Macro-level constraints of fragile contexts, such as political and economic instability, infrastructural deficiencies, weak human capital, and low state capacity limit the supply of investable opportunities, increase project costs, and threaten the viability of investments. In addition, there is a lack of established firms that could form networks with suppliers and buyers on which projects rely or serve as comparison cases for business and corporate strategy decisions. This is worsened by a broader scarcity of information on the local market, its risks (both actual and perceived), and the costs of operating in that environment.

3.4.2 Shareholder challenges

Shareholders have increasingly called for a bolder role for DFIs in fragile contexts, but many still expect DFI investments to meet rigid investment requirements. DFIs are often required to maintain AAA credit ratings, invest at commercial terms, avoid losses, and promptly meet ambitious environmental, social, and governance (ESG) standards. These criteria tend to apply with the same stringency across global investment portfolios, rather than being tailored to different contexts. This limits DFIs' ability to pursue potentially high-impact investments in fragile settings where risk is systematically higher, financial losses nearly inevitable, returns can take years to materialise, and ticket sizes tend to be small.

⁵⁴ Carter et al. 2018.

⁵⁵ Ibid., Attridge & Engen 2019.

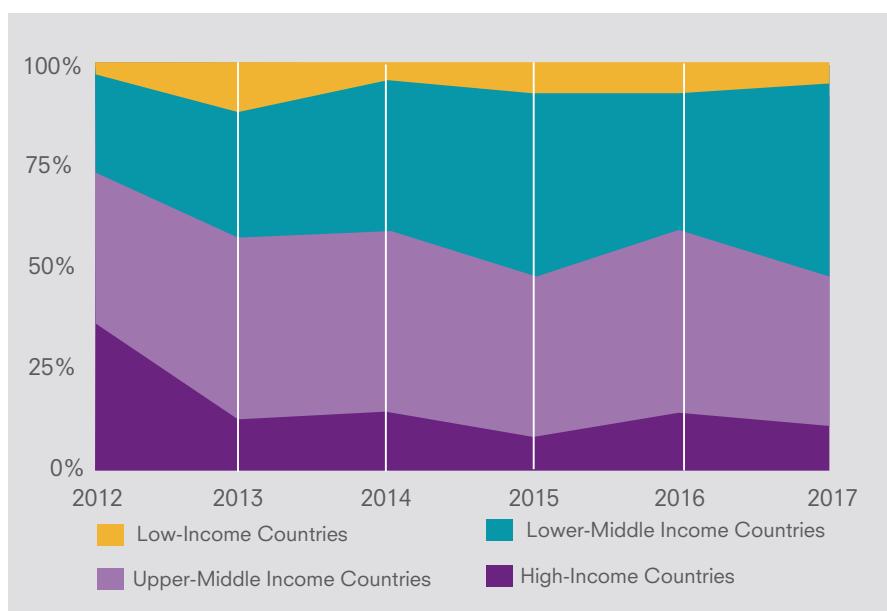
⁵⁶ Carter et al. 2018.

⁵⁷ Kenny & Moss 2020.

3.4.3 Internal challenges

DFIs face internal barriers stemming from their corporate culture and traditional ways of working that tend to endorse risk aversion and focus incentives mainly on deal making. To the extent that DFI staff are rewarded primarily for successful dealmaking, this may encourage effort towards easier, often higher-income, environments at the expense of fragile settings, which contributes to the trends seen in Figure 2. Project failure also continues to be stigmatised, rather than broadly accepted, despite failure being more likely in fragile environments. Indeed, a lack of failure is likely a clear indication that DFIs are not venturing into the difficult environments where their ability to facilitate private sector entry is vital. Finally, teams in fragile contexts often suffer from limited resources and fewer senior staff on the ground compared to teams in less fragile settings.

Figure 2: DFI investment by country income (%)⁵⁸



3.4.4 Reputational concerns

Investing in fragile settings exposes DFIs to greater reputational risks than in non-fragile environments because of the complex local conditions, weak logistics and supply chain networks, and challenging social, economic, and political dynamics that make meeting IDD and ESG requirements challenging.⁵⁹

Realism is needed in very difficult settings – without this, investments will not be made and there will be no progress toward creating much-needed economic opportunities in these contexts. A more viable approach could be to agree on a timeline for investments to progressively come into compliance with ESG, labour, and other regulatory requirements – with strong accountability measures kicking in should milestones be missed.

⁵⁸ Center for Global Development 2020.

⁵⁹ McVeigh 2019.

4 Policy considerations for improving development finance in fragile settings

Efforts to kickstart private sector development in fragile settings have made limited progress to date, necessitating rethinking of past approaches. Here, we detail policy considerations that development finance actors could bear in mind when investing in fragile contexts.

4.1 Renew DFI institutional culture

DFIs' approach in fragile environments has often been compared to that of commercial investors due to a high reliance on debt for a limited number of projects and a prioritisation of financial returns. This cautious approach keeps DFIs from playing a more transformative role in fragile settings as, in an effort to ensure project success, they may fail to assume those risks that pioneering firms cannot bear alone. DFIs' risk aversion stems partly from institutional culture and corporate practices, which can be transformed to align with two principles:

- **Define success in terms of jobs created, not deals** – Defining and rewarding DFI staff success primarily on the basis of number of transactions and size of deals disincentivises efforts in fragile situations where ticket sizes are smaller and it takes more time and resources to conclude deals. Generating decent jobs at scale, or contributing to productivity increases, should be accepted as metrics of success to be similarly measured and rewarded. A more comprehensive score card approach has already been adopted by some DFIs.
- **Accept failure** – The likelihood of failure is high given the complex challenges and risks that fragile environments present. DFIs should accept the non-trivial probability of failure and proceed in these contexts with a high risk tolerance, as the transformational role they can play is only possible if they take on risks. Where DFIs should draw the line with risks is not straightforward, however, as investments that lose them money limit their scope for future investments, so recklessness is similarly problematic. Nonetheless, failure, especially if resulting from innovation and experimentation, should be seen as an opportunity to learn and build up knowledge on highly uncertain environments. Institutional processes should be developed so that such knowledge is internalised by and shared among investment officers, who are then better equipped to pursue other projects in fragile settings.⁶⁰

Beyond these considerations, it may be necessary for some DFIs to adjust in order to make themselves fit-for-purpose for operating in fragile contexts. They may not currently have the mandate, expertise, or in-country presence needed to take on challenging investments with the potential to make transformational contributions in fragile settings.

⁶⁰ Collier et al. 2019.

4.2 Strengthen inter-institutional collaboration

Development finance players have different yet complementary mandates, specialisations, and focus areas. This has often led them to act in an uncoordinated, siloed, and somewhat competitive manner. While some competition can promote discipline and innovation, excess competition is wasteful and counterproductive. This is especially true in fragile contexts, where the benefits of collaboration far outweigh those of competition. Greater collaboration enables the sharing of information and spreading of risks and costs, which ultimately improves the chances of project success. There are two key levels of collaboration that need to be scaled up: inter-DFI collaboration and DFI-aid agency collaboration.

4.2.1 Inter-DFI collaboration

To lower the risks and costs associated with working in fragile contexts, a collaborative approach to investment, based on pooling resources across DFIs, could help overcome barriers and increase the chances of success. Collaboration is also conducive to facilitating the entry of multiple firms into a fragile context, which is relevant as firms are more likely to enter these settings if they do not go alone. Guided by a common purpose, multiple DFIs operating in a given sector can identify and attract firms from their home countries that could be supported to enter these markets. Acting in concert and with a shared voice also strengthens DFIs' dialogue with governments, making it more likely that DFIs can push for necessary reforms.

To the extent possible, co-financing efforts should be institutionalised through formal structures such as special purpose vehicles (SPVs):

- **Special purpose vehicles** – SPVs managed by multiple development finance stakeholders would consist of joint funds with equity participation which should focus on development impact, mobilisation of private finance, market creation, improving the enabling environment, and tackling drivers of fragility. It would operate in the country of investment and DFI staff would be seconded to the SPV and would work for the SPV's mandate rather than that of the DFI.

Lying outside the financiers' own balance sheets, the SPV arrangement has the benefit of having less of an impact on institutional credit ratings. Plus, being a separate entity could enable the SPV to take on greater risk at arms' length from DFIs. This type of facility should provide risk-absorbing tools, such as local currency investments, junior debt, guarantees, and a greater use of equity. Prudential management would be ensured through realistic financial requirements such as capital preservation, rather than unviable thresholds for risk-adjusted commercial returns for investment viability.⁶¹

The creation of an SPV does not come without challenges and transaction costs, however, especially concerning the varying interests and objectives of both the financiers and the users of the fund, mainly DFIs. Significant resources must be allocated to coordination, fund strategy, transparency disclosure, and harmonisation of practices and standards. Options such as thematic SPVs that can accommodate the specific interests and risk appetites of different DFIs in a particular fragile setting should be explored.

⁶¹ Ibid.

Additional forms of collaboration that should be pursued include:

- **Co-financing of upstream work** – Investing in fragile contexts demands considerable preparatory work to develop project pipelines, including risk assessments, technical assistance, training, and the regulatory and institutional development needed for a conducive enabling environment. Another critical area is supporting the establishment of large domestic firms, who can then serve as the capable and clean sponsors that are so scarce and otherwise constrain DFIs from investing in fragile contexts. Few DFIs are currently set up to support the establishment of local firms.

The time and expense involved in upstream activities can be considerable. Since upstream work can benefit multiple projects across different sectors and because it needs to leverage diverse skills, it represents a key area for collaboration as a tool to reduce costs and improve impact. DFI joint efforts would likely entail a wide range of early-stage upstream work that scopes whole-sector or whole-market opportunities, rather than individual deals, accommodating varying interests and objectives of DFIs.

- **Harmonisation of practices and standards** – Developing common policies and practices in fragile contexts can contribute to reduced overhead costs and would facilitate co-financing frameworks. Harmonised approaches could involve the adoption of shared ESG standards or reporting and diagnostic tools that can be replicated across settings and shared across institutions.
- **Joint data production** – Scarcity of comparable information about the local markets and investment performance raises uncertainty and investors' search costs and risks, and thus hinders investment. DFI joint efforts to collect and share comparable data through a common platform represents a practical solution for these challenges.

4.2.2 DFI-aid agency collaboration

The public good potential of investments in fragile contexts warrants the use of aid funding to make them possible. Many investments, even those with catalytic potential, such as scaling energy or connectivity infrastructure, are simply not financially viable for the private sector to take on unassisted in fragile settings. High returns can only be realised through elevated service costs that those living in fragile states cannot afford. Aid funding, in the form of de-risked loans or outright grants, is able to accept lower rates of return and therefore has a critical role to play in making these investments possible.

Coordinating infrastructure development to meet the needs of specific sectors that are being built out and pioneering firms that are being attracted into these markets requires close coordination between aid agencies and DFIs. Coordination should extend beyond single investments and should support dialogue on private sector development between DFIs, aid agencies, and government.

4.3 Coordinate with government and civil society

A constructive dialogue with government officials should be undertaken early on in project consideration and serve as a tool to scope out sector potential. On the basis of these discussions, development finance actors should develop sector strategies for their efforts that are aligned with government plans. DFIs should also commit to working *with* governments, rather than *around* them, even where government capacity is very limited in fragile states, to ensure that sponsored projects have government buy-in.

NGOs and civil society groups also have a key role to play in private sector development in fragile contexts. Strengthening ties with these groups and developing collaborative relationships is an important tool for shared learning and better understanding of respective aims, efforts, and challenges. Oversight and guidance from NGOs and civil society could help ensure that private sector development does not aggravate tensions or conflict through skewed benefit distribution and could also mitigate reputational risks by allowing development finance actors to be more informed of social and political developments that may impact investments.

4.4 Invest in financial intermediaries

Small ticket size is a key constraint to increasing DFI investments in fragile contexts, due to overheads comprising a disproportionately high share of costs. Investing in local financial intermediaries, such as local banks for debt and venture capital funds for equity, is an effective way to reach SMEs with DFI and aid financing. These investments provide support to the local financial sector, enabling its development over time. Investment in financial intermediaries appears to be especially additional in fragile settings as it targets the “missing middle” between commercial finance and microfinance, and increases competition in financial markets that are often controlled by few firms. DFIs are also able to benefit from the deep local market knowledge that local financial intermediaries possess.⁶²

Local banks and venture capital firms have limited capacity in fragile contexts. This is particularly true for venture capital firms, which are very rare in fragile settings. DFIs will have to undertake upstream work to build competent local banks and attract venture capital fund managers to strengthen financial intermediary capability in fragile settings. A good example of a DFI doing this is IFC’s SME Ventures initiative, which provides finance with a higher risk tolerance than bank loans (in the form of equity, loans, and quasi-loans) and targeted technical assistance to entrepreneurs and fund managers as they work to establish themselves in challenging markets.⁶³

4.5 Leverage innovative financing tools

The exceptional challenges presented by fragile environments require innovative approaches to tackle them. Policies copied from elsewhere and business as usual approaches will not work in fragile contexts. The pervasive radical uncertainty of these settings means that discovering what works will only result from sustained, iterative experimentation and active inter-institutional learning and lesson-sharing.

⁶² Carter 2020, IFC 2019.

⁶³ IFC 2018b.

Experimentation and innovation should cover the tools and mechanisms of collaborative financing frameworks and develop new products that enable DFIs to assume greater risks in fragile environments and to incrementally strengthen financing mechanisms through application.

4.5.1 Blended finance

Blended finance is a co-financing strategy which involves combining concessional finance from aid budgets with commercial finance from DFIs and the private sector. It has been gaining traction as a tool to maximise the mobilisation of private capital to achieve philanthropic objectives such as the SDGs.⁶⁴ In fragile contexts, blended finance can be a powerful de-risking tool. Combining DFI resources with subsidised capital helps to lower the investment risk in fragile contexts and crowd-in private capital. It also represents a practical avenue to operationalise collaboration across diverse stakeholders to pursue the twin goals of private sector growth and socio-economic development.

So far, mobilisation ratios from the deployment of blended finance in low-income countries has been weak in terms of project size and geographic and sectoral focus.⁶⁵ Moreover, blended finance tends to have higher transaction costs than other DFI investments as it involves additional layers of negotiation and collaboration between DFIs and aid agencies. Little information on blended finance investment performance has also been cited as an impediment to it being scaled up.⁶⁶ While blended finance has the potential to reduce risks and costs associated with establishing new markets, thereby mobilising private finance for fragile contexts, measures must be taken to improve its effectiveness. Examples include:

- **Increasing capacity** – Blended finance still constitutes a minor portion of total DFI investments and some suggest that creating additional lending headroom would be viable.⁶⁷ Greater capacity alone might simply reinforce current trends, however, with no factual shift of capital towards low-income countries or fragile contexts – therefore, more fundamental strategic changes may be required.
- **Invest in private sector fundamentals** – Arguably, high market risk drives away blended finance from fragile contexts. Substantial and holistic investments in strengthening enabling environments are needed to lower risk perception and enable local private sector actors to function more effectively.
- **Coordination** – Improved coordination among DFIs and donors, especially through shared and standardised investment approaches, could lower overhead costs and increase DFIs' access to blended finance.
- **Transparency** – Making information on blended finance investments available is a critical factor to fostering cross-institutional learning, shareholder confidence, and, thus, mobilising additional resources.

⁶⁴ AfDB et al. 2019.

⁶⁵ Attridge & Engen 2019.

⁶⁶ AfDB & Convergence 2017.

⁶⁷ AfDB et al. 2017, AfDB et al. 2018, AfDB et al. 2019.

— **Shareholder management** – Educating shareholders about the potential impact that blended finance could have on driving development in fragile settings is critical, as is raising awareness of the role that imposed risk-return thresholds may be playing in holding DFIs back.

4.5.2 Social impact bonds

Although definitions of social impact vary, a social impact bond or ‘pay for success’ agreement is “a public-private partnership financial instrument in which investors pay for a set of interventions to improve a social outcome that is of social and/or financial interest to the commissioner, usually or traditionally a government. In other words, the government pays private investors a return for funding successful social projects that meet measurable outcomes.”⁶⁸

These could be tailored for fragile contexts and used to de-risk or aggregate investments into fragile states for the purpose of creating jobs and consolidating peace.⁶⁹ The commissioner could either be an international organisation or development agency (rather than a government) or a special entity formed by DFIs and/or aid agencies to guarantee payment of returns to investors in the event that the government of the fragile state is unable to pay.⁷⁰ To overcome the issue of small loans sizes and high overhead costs of structuring and implementing social bonds, many small loans to fragile states could be aggregated to increase bond size.

4.5.3 Political risk insurance

Political risk, arising from war, asset expropriation, contractual breach, or prohibitions on exports, is an important deterrent of investment in fragile settings. Political risk insurance is a tool that protects against investment losses that may result from these events. However, in fragile contexts it remains limited or prohibitively expensive and is often available only to foreign investors. Efforts to scale up political risk insurance to make it more affordable as well as available to local investors could be valuable in catalysing greater investment into fragile markets. Multilateral institutions, such as MIGA, are best placed to drive this as they can assume greater risk than private insurers, offer longer tenure of coverage and lower, more constant premiums, and can use their institutional influence to mitigate disputes between government and investors.⁷¹

4.5.3 Currency management instruments

DFIs and foreign investors have hard currency balance sheets, exposing them to currency risk, particularly in fragile states where macroeconomic instability is common. Sectors that earn foreign currency through exports, such as extractives and agri-business, are slightly less risky.

⁶⁸ Garrasi et al. 2017.

⁶⁹ Ibid.

⁷⁰ Ibid.

⁷¹ Mayer 2018.

To finance more firms in fragile contexts, currency risk needs to be addressed. This can be done through currency management instruments, such as the IFC's Local Currency Facility, which provides long-term local currency in IDA countries where market solutions are not available or capital markets are not sufficiently developed.⁷² This facility provides protection to clients operating in contexts where currency hedging options are limited or absent.⁷³ As with political risk insurance, ensuring that currency management instruments are affordably priced for fragile contexts and made available to both domestic and foreign investors is central to scaling up its usage among investors.

⁷² IDA n.d.

⁷³ Ibid.

6 Conclusion

Pioneering firms and investments can serve a **catalytic role** in challenging contexts through establishing new markets, training labour, creating jobs and income-generating opportunities, developing supply chains, and supporting governments to improve the country's broader enabling environment for private sector growth. But these firms cannot take on this task alone – nor should they be required to. The higher risks and costs they incur have the potential to generate **public goods** that benefit others. It is essential that mechanisms to offset the additional costs they incur are available.

Development finance can play a vital role in this. Although development finance alone is not sufficient to drive private sector growth, it can be deployed strategically to de-risk early investments and crowd-in private investors, whose financial resources are considerably larger than aid volumes. **DFIs** are well placed to lead this early investment process through proactive coordination, collaboration, risk-taking, inter-institutional learning, and innovation. Through leveraging different sources of financing and driving the upstream work needed to develop project pipelines, DFIs can play a central role in igniting private sector growth, which is critical to moving fragile contexts out of cycles of low-productivity, unemployment, and fragility toward more positive development tracks.

For DFIs to successfully fulfil this role will necessitate some changes in the way they work. First, their institutional culture and corporate practices could better align staff incentives with development impact outcomes, such as job creation and raising firm productivity, rather than focusing primarily on the number and value of investments made. DFIs will also need to become more comfortable with failure, given its significantly higher likelihood in fragile contexts.

Increased collaboration with other DFIs and aid agencies is essential to achieving coordinated, complementary efforts that could also spread risks and costs across institutions. This collaboration can take many forms, including pooling funds to co-finance upstream work, harmonising practices and standards, jointly producing and sharing data, and coordinating investment projects while attracting investors into particular sectors.

Although government capacity in fragile settings is often extremely limited, it's vital that DFIs work *with governments* rather than around them. Government should have buy-in to investment projects, and projects should align with government priorities. **NGOs** and broader **civil society** in fragile contexts are important partners for DFIs: among other things, they can provide valuable oversight and guidance to ensure that investments do not aggravate tensions or conflict.

Working through **local financial intermediaries** – local banks for debt and venture capital firms for equity – would enable DFIs to reach SMEs and support smaller ticket sizes while minimising overheads, strengthening local financial markets, and leveraging the deep local market knowledge that local financial intermediaries possess.

A number of **innovative financing tools** can be used to boost investments in fragile contexts, including blended finance that uses public funding as a powerful de-risking tool to crowd-in private capital. Social impact bonds that allow investors to pay for defined interventions to improve social outcomes could also be tailored for fragile contexts. Political risk insurance, currency management instruments, and other tools to support investments could be significantly scaled up through more affordable pricing for fragile contexts and extending eligibility to domestic as well as foreign investors.

Job creation and private sector development have considerable potential to support countries moving out of poverty and fragility, warranting the use of **public funding** for these purposes. However, the positive, public good nature of these developments is not guaranteed. In fragile and conflict-affected settings, private sector activities just as often aggravate ethnic and regional inequalities and perpetuate conflict. If the distribution of benefits of economic growth are unequal and contested, private sector development may deepen societal divides. To guard against the negative impacts of private sector development in these contexts, careful regulation of the private sector, **context-specific strategies**, and comprehensive approaches to conflict sensitivity are needed.

Financing private sector growth in fragile, conflict-affected, and post-conflict settings is not straightforward and requires leveraging finance across both the public and private sectors. Achieving the SDGs and global socio-economic prosperity will not be possible until millions of people living in settings of conflict and fragility are able to access the economic opportunities and improved public services needed to progressively lift them out of poverty and instability. Peace and stability have priceless domestic benefits, but also significant regional and global gains – supporting these environments in transitioning out of fragility is undoubtedly a global good and an urgent priority.

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