

# How do development finance institutions support national development goals?



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## Key messages

- Development finance institutions (DFIs) are generally averse to national development plans shaping their investment decisions and funding allocation.
- Our study found that DFI funding is low in some sectors that countries identify as national development priorities, including manufacturing in Ethiopia, healthcare and ICT in Ghana, and transport and ICT in Kenya. This presents commercial opportunities for additional DFI investments.
- DFIs risk losing out on these and other opportunities to enhance their development impact if investment decisions are solely led by the private sector.
- A framework for assessing alignment between DFIs' investment portfolios and national development priorities is critical to unearthing additional opportunities for many DFIs.
- DFIs suggest that more targeted engagement with governments could be an optimal strategy in different contexts.

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This policy brief summarizes findings from the report *Understanding the Role of Development Finance Institutions in Promoting Development: An Assessment of Three African Countries*. The report comprehensively assesses the role of DFIs in supporting development objectives in three countries – Kenya, Ethiopia and Ghana – and asks about their development plans and whether DFIs allocate resources to sectors that each country identifies as strategic priorities (see Table 1). The report includes the perspectives of six DFIs: Swedfund, Norfund, Finnfund, DEG, IFC and CDC.

## Development finance institutions and development

DFIs are financial actors that invest in private sector firms and funds for which they expect a financial return. At the same time, DFI shareholders also expect DFIs to contribute to development objectives such as the Sustainable Development Goals (SDGs). Ideally, DFIs would invest in areas that contribute most to development objectives but, in reality, they are guided by viable private sector opportunities and the extent of their own resources. In some cases, activities with the greatest social returns may not be financially viable and hence not ready for DFI support. In other cases, private sector opportunities may have minimal impact on development but already receive private finance and may not be eligible for DFI support.

IMAGE (ABOVE): Nairobi, Kenya  
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DFIs already contribute to development objectives in various ways, such as through job creation and tax contributions, by choosing to invest in already profitable private sector opportunities with development impacts. They tend not to invest in nascent opportunities that would have an impact but are not yet profitable.

### Three main DFI goals

DFIs aim to achieve the following three broad goals:

- 1. Generate additionality.** This can be broadly divided into development impacts, financial additionality and value additionality (OECD, 2018). Concerning financial and value additionality, DFIs need to provide additional services to the financial market, not the provision of competitive services of existing private investors. DFIs provide equity or debt finance through better financial terms (e.g. more extended debt repayment periods, or reduction or removal of collateral requirements). They also provide finance to firms that have difficulty accessing commercial finance (e.g., start-ups or SMEs, or firms in sectors less well known to domestic financial institutions). They also act as risk-mitigating or risk-sharing agents and provide technical assistance for stakeholders in their investments.
- 2. Development impacts.** DFIs aim to harness the power of the private sector to promote development outcomes such as economic growth, employment, and contributions to government revenue.
- 3. Catalytic or demonstration effect.** DFIs can prove to the commercial sector that investments they may have previously not considered (either because of a lack of knowledge or they were considered too risky) may be commercially viable. This demonstration could potentially spur domestic and other commercial financial institutions to carry out similar investments in the future. Part of their catalytic agenda is also to spur other DFIs to invest.

In addition, DFIs are increasingly looking at how their investments contribute to the Sustainable Development Goals (SDGs). Research has shown where DFIs have had a proven impact on the SDGs, particularly on job creation, and on energy and climate change, which are relevant to SDG 7 (energy), SDG 8 (promoting economic growth) and SDG 13 (combating climate change). DFIs contribute to tackling climate change by investing in clean energy, such as hydropower or solar energy, both for on-grid and off-grid energy supplies, thereby contributing to SDG 7. DFIs are also increasingly aligning themselves to the Paris Agreement. For example, Swedfund, FMO and Proparco explicitly mention that their investments should contribute to achieving the Paris Agreement and SDG 13.

While DFIs have continued to contribute to many development outcomes in different contexts, the question remains whether they could do even more and be more strategic. Our assessment of various national development policy guiding documents in Ghana, Ethiopia and Kenya demonstrates significant funding gaps in strategic sectors and underinvestment by DFIs in those sectors. If these opportunities were mapped to DFIs' investment decisions, DFIs could perhaps have a greater impact in delivering on their mandate.

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## Mapping financial flows onto development priorities in Ethiopia, Ghana and Kenya

### Identification of development priorities

Table 1 summarizes the identified strategic sectors of Ethiopia (2015–2020), Kenya (2018–2022) and Ghana (2015–2020) based on a focused literature review of official policy documents (published country strategies or development plans, and annual budget statements, among other policy announcements).

Table 1: Summary of identified strategic sectors

Sectors	Ethiopia	Ghana	Kenya
Agriculture	X		
Construction	X	X	
Energy		X	X
Finance			
Education			X
Transport		X	X
Tourism			
Manufacturing	X		X
Healthcare		X	
ICT		X	X
Retail			
Extractives			

### Alignment between development plans and the SDGs

A review of the development plans of the countries in this study show that some development strategies make explicit reference to the SDGs, as in the case of Ethiopia. In other cases, the link to the SDGs is more implicit. This notwithstanding, the advancement of all countries' development plans is expected to advance the SDGs because they all focus on economic, social and environmental objectives.-

### Financial flows and development priorities

We mapped different financial flows for the case study countries, for example, DFI investments, foreign direct investment (FDI), commercial finance (credit provided by the banking sector) and official aid (i.e. Official Development Assistance, ODA) against the strategic sectors identified in the development plans. The aim was to understand how these financial flows align with investment in the strategic sectors. This exercise is challenging for several reasons, not least because of the degree of sector specificity for announced financial support measures .

Across all types of financial flows, Ethiopia showed the strongest alignment with investment in strategic sectors. In terms of DFI finance alone, (excluding investment funds) alignment was highest in Ghana, followed by Kenya. In terms of non-DFI commercial finance (e.g. private banks) there was most alignment in Ethiopia and least in Ghana. For ODA, there was most alignment in Kenya, with Ghana and Ethiopia scoring similarly.

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## Opportunities and challenges

The preceding assessment of financial flows against development priorities presents both opportunities and challenges. Our analysis shows which of the three countries' strategic sectors have received significant DFI investments, and whether other forms of finance are funding sectors that are not supported by DFIs. Below is a summary of the findings:

- Ethiopia: DFIs are financing the agricultural sector, while less finance is going to Ethiopia's other strategic sectors, i.e., manufacturing and construction. However, there is some commercial finance flowing into these two sectors.
- Ghana: there appears to be adequate DFI funding in the energy and transport sectors, while there is underfunding in construction, healthcare and ICT. Domestic commercial finance flows to the construction sector, while ODA funds healthcare. The ICT sector is receiving some funding through Foreign Direct Investment (FDI).
- Kenya: the energy and manufacturing strategic sectors receive adequate DFI funding, whereas DFIs underfund the education, transport and ICT sectors. The transport and ICT sectors receive some funding from ODA.

While the above opportunities could benefit DFIs looking for strategic investments, the challenge remains to ensure financial additionality, development impact, and catalytic effects. For example, on financial additionality, the question of *where DFIs should concentrate their efforts so that they encourage private sector flows and do not overlap with existing financial flows* is not always easy to answer.

## DFIs and national development plans

We interviewed six DFIs in our study, first to explore how they use development plans, and second to learn the extent to which they engage and liaise with governments and other actors in sourcing and developing projects for investment and throughout a project's lifecycle. Key insights from the interviews are summarized below:

- DFIs are not all alike – they differ in terms of governance, mandate, size, and business models. These factors affect how they use development plans and the extent to which they engage with other actors.
- DFIs are acutely aware of the need to understand the local political context and enabling environment because these factors have a substantial impact on investment risk and commercial viability. As part of project due diligence, DFIs map countries' macro and regulatory environments, as well as development agendas and political contexts, but for most DFIs these are treated as given risk factors in the investment calculus.
- DFIs are sceptical about the quality of many countries' development plans and how far they guide government behaviour. For some DFIs, the SDGs should be the starting point for this discourse and not country development plans.
- None of the DFIs interviewed said that alignment of DFI investment to development plans is an explicit determinant of investment. However, in some cases development plans may inform due diligence as part of project evaluation.

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- While DFIs recognize government buy-in is often essential, they do not view a lot more interaction as always beneficial.
  - Most DFIs we interviewed indicated that they align implicitly with objectives on energy and infrastructure and financial inclusion, where they are included in development plans, given that they invest in infrastructure and have sizeable financial sector portfolios.
  - Should challenges around the enabling business environment affect the commercial viability of a potential project, DFIs may reach out and engage the support of local embassy staff or their country development agency to address these issues with the government, rather than engage directly.
  - DFIs are currently using coordination pilots (country platforms) in some countries, for example in Ethiopia, where a platform is co-led by CDC and IFC.<sup>1</sup> This platform has led to direct information exchange and an understanding of upstream constraints to investment. While DFIs view this as positive, there is room for follow-up with governments on investment constraints.

## Four steps DFIs could take to align investment flows and country-level strategic sectors

Our study sheds light on the role of DFIs in supporting the objectives of national development plans set by developing countries, particularly those emphasizing the SDGs. It also demonstrates opportunities and challenges for enhancing the impact of DFIs, especially the value of more engagement on these issues among relevant stakeholders. A central finding is that DFIs are not significantly considering national development plans in their operations and appear to be operating mainly in line with their internal objectives and strategies. However, DFIs do recognize that there may be opportunities to do so through structured, but limited and targeted, interactions.

Our report suggests four steps DFIs could take to increase alignment between their investment flows and country-level strategic sectors.

**Step 1. Identify:** The first step is to identify the strategic sectors that governments are looking to develop, mainly to understand the dynamics of economic and social impacts that government strategies seek to achieve and whether these outcomes are achievable and based on sound strategies. Identifying a country's development priorities can also signal the direction of political incentives.

**Step 2. Compare:** DFIs can compare the identified sectors with their current investment strategies to understand how well they fit together. The next step is to compare those sectors with their country investment portfolios to see where they are already well placed, where DFI funding is lacking, and where finance is the binding constraint. A framework for this comparison could adopt the methodology used in our study. DFIs would also develop a clearer picture of the sectors that domestic finance and FDI financial flows are moving into, which could help DFIs understand if they need to be involved in financing projects in strategic sectors or whether these sectors are already well covered by existing sources of finance. The comparison should also seek to understand what types of firms may be receiving finance and whether segments (such as SMEs) are underfunded.

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<sup>1</sup> IFC is the only DFI that has local offices in most countries and country strategies based on private sector diagnostics. This would be too expensive for many smaller DFIs.



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However, it is essential to note that not all DFIs have the resources to tailor their investment strategies to each country. Larger DFIs such as the IFC could carry out such an activity, while smaller DFIs may have to allocate resources more strategically, for example by prioritizing countries where they invest the most.

**Step 3. Engage:** After DFIs have identified a role in funding strategic sectors, they should engage with three key groups of stakeholders:

- Representatives of interested sectors: Discussions with, for example, firms of different sizes and business associations would help DFIs understand current financing and technical constraints that inhibit the growth of firms in the strategic sector and how DFIs could help (e.g. through finance, technical assistance, provision of international linkages).
- Domestic financial institutions and potential foreign investors: Discussions should focus on understanding the financing constraints on the supply side and what role DFIs could play (e.g., providing risk-sharing funds for domestic financial institutions or mitigating risks for foreign investors through local knowledge or technical assistance).
- Interaction with governments: The aim of such discussions would be to:
  - make the government aware that the DFI is interested in contributing to the growth of target strategic sectors, and to then set up official communication channels between the government and the DFI
  - make the government aware of potential growth constraints it could resolve (e.g., environmental policies for business, trade policies)
  - understand in greater depth the types of impact the government expects to have by promoting these strategic sectors, thereby enabling DFIs to make more targeted investments.

**Step 4. Invest:** The final step would be to scope out opportunities for feasible investments in the target strategic sectors. This involves sourcing profitable private sector opportunities. The DFI would then look for suitable investment partners (e.g., domestic financial institutions, foreign firms, other DFIs). It would also provide any required technical assistance and liaise with the government to assess whether policy constraints could be eased.