

GREAT insights

GOVERNANCE REGIONAL INTEGRATION ECONOMICS AGRICULTURE TRADE

Financing development

Exclusives:

Prospects and policies
for ensuring public
debt sustainability
in Africa

Prof. Mthuli Ncube, Chief
Economist and VP, & *Zuzana
Brixiová*, Advisor, AfDB

The post-2015
challenge
for development

Werner Hoyer, President,
European Investment Bank

Maximising the
'Beyond Aid'
Approach

Bankole Adeoye, Director
Corporate Services, NEPAD

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Editorial

How to finance development? This is the challenge developing countries have been confronted with for decades, and will continue to be so for years to come. But in a rapidly evolving world, the challenge is taking new dimensions.

Developing countries are becoming increasingly assertive in determining the course to follow. Rapid economic growth and the commodity boom have generated increased confidence in a growing number of countries, in particular Africa, to focus on their own resources to finance their economic transformation and development. Sound macroeconomic management combined with a robust economic recovery following the 2008 global financial crisis has also contributed to this new assertiveness, as well as ensuring the debt sustainability of many African countries (as argued in this issue by the Chief Economist and Vice President of the African Development Bank, Prof. Mthuli Ncube and his advisor Zuzana Brixiová).

Several African countries and institutions have recently dedicated significant efforts to better identify and tap into various, sometimes new (at least for governments) sources of financing, including from within Africa. These include issues such as better and smarter tax systems, increased reliance on stock markets, bonds and equities, greater involvement of sovereign wealth funds (don't miss the insights by Alan Gelb, Silvana Tordo and Håvard Halland in this issue), harnessing some of the remittances flows, or tackling illicit financial flows (as argued by Momodou E. Touray on page 27). Bankole Adeoye, Director at the NEPAD Agency, offers a concise overview on these questions.

The African concerns are somewhat echoed by the international debate on financing for development, as currently framed by the debate on post-2015 framework. Beyond continued support to some of the poorest countries in the world, aid is losing traction as a key source of financing for development. Instead, the debate has shifted to the leveraging effects official development assistance can have on development dynamics and other sources of finance, as discussed by Erik Solheim, the Chair of the OECD Development Assistance Committee, and in another article by Dirk Willem te Velde.

The future of financing development, including in frameworks such as the post-2015 agenda and the African Agenda 2063, must build on a greater recognition of developing countries own strategies to drive and finance their own structural transformation. Efforts should therefore aim at strengthening and further developing national and regional mechanisms in developing countries, notably in mobilising domestic resources for development, including by enhancing their financial sector and markets. It should focus on providing greater opportunities for multi-faceted public and private sector engagement. Private investment and finance is likely to be the key engine for growth, as argued by Jyrki Koskela on page 34, with domestic and international development partners contributing through a range of incentives, instruments and initiatives to leverage or accompany private engagement, with a greater focus on sustainable and inclusive outcomes harnessed to the development agenda of developing countries and regions.

In this context, the role of international financial institutions, development finance institutions and other development banks can be instrumental. Lessons and new endeavors by the European Investment Bank, as highlighted by its President Werner Hoyer in his lead article, or from innovative initiatives such as the IFC Catalyst Fund, presented by Dr. Reyaz Ahmad and Johanna Klein, are most promising in that respect.

We hope that this issue of *GREAT Insights* usefully contributes to this debate.

Dr. San Bilal (Editor), *Head of Economic Transformation Programme, ECDPM*.



Prospects and policies for ensuring public debt sustainability in Africa



New Central Bank Tower, Nairobi, Kenya

Shortly after being hit by the global financial crisis in 2009, Africa staged a robust economic recovery and was one of the fastest growing regions in the world. The continent's performance is projected to remain strong despite the fragile and tepid global recovery. As several studies and scholars have now pointed out, Africa has the potential to become a global growth pole over the longer term. However, vast infrastructure and human capital gaps constrain Africa's development. Balancing the need to scale up growth-enhancing public outlays and debt sustainability is therefore a key policy challenge ahead.

What constitutes sustainable levels of public debt may need to be reconsidered in the context of Africa's high economic growth rates, reduced risk premia, low interest rates, and strengthened debt management capacity. During the past decade, debt sustainability has improved markedly and Africa's debt-to-GDP today is lower than in decades. Still, the global financial crisis has left some countries with looming fiscal challenges and deteriorating public debt sustainability.

The fiscal legacy of the global financial crisis in Africa

African countries – which entered the global financial crisis with overall low debt levels, adequate foreign exchange reserves, and moderate inflation – experienced the crisis shock mostly through cuts in external demand and liquidity shortages. Where policy buffers allowed, governments adopted counter-cyclical responses to the

crisis, usually in the form of increased capital outlays and/or monetary easing.¹

Overall, the global financial crisis has left African countries with weakened fiscal (and current account) balances. Specifically, four years after the crisis, fiscal balances remain lower than before the crisis in about two-thirds of African countries. While the magnitude of the continent's fiscal deterioration is similar to that in other developing and emerging market countries, its drivers differ. Unlike in richer countries where the increased deficits were caused mostly by stimulus policies, in Africa external shocks played an important role. Figure 1 shows how key pre- and post-crisis fiscal indicators of African countries compare to other global groupings, as well as key differences within African groupings.

In general, countries with stronger fiscal positions at the outset of the crisis implemented more decisive counter-

cyclical measures and experienced larger deterioration of their fiscal balances. Most of the other countries, especially fragile states, could not adopt counter-cyclical measures during the crisis, due to limited fiscal policy buffers and access to borrowing. Their fiscal balances have thus weakened less than those of the frontier markets. These countries have posted current account deficits in double digits, raising concerns about vulnerability to external shocks.

As indicated in Figure 1, Africa's public debt-to-GDP ratio declined during the 2008 – 2012 period, as widened primary fiscal deficits (i.e. deficits net of interest payments) were offset by factors such as low or negative real interest rates, high growth, and debt relief in some low-income countries.

Grouping the countries by income shows that the total public debt increased in middle-income countries and declined in low-income countries. Two observations stand out. First, albeit rising, the overall debt level in middle-income countries is still markedly lower than that in low-income countries. Second, the current African debt

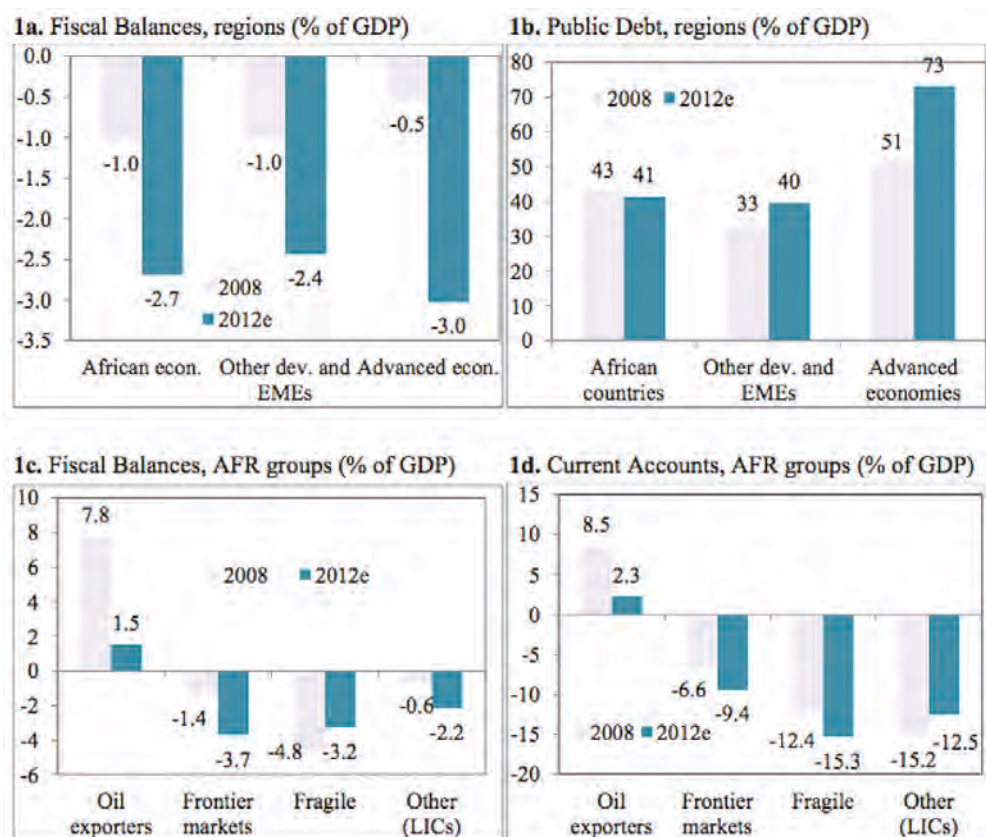
is the lowest in decades, with the fastest decline posted by the most indebted countries thanks to debt relief and accompanying prudent policies that made the relief possible. As the composition of public debt has shifted from external to domestic (and from official to unofficial) creditors since 2000 while external reserves rose, countries' vulnerability to external shocks has subsided.

While the relatively low overall public debt levels and declining trend are positive signs, they do not leave room for policymakers' complacency. Vast differences among countries prevail. Further, there is no predetermined debt threshold that would indicate that fiscal (solvency) crisis is about to occur. While it is clear that higher public debt makes a country more vulnerable to a crisis (other factors being equal), it is not possible to determine the specific tipping point. Moreover, widening fiscal deficits indicate shorter-term fiscal vulnerabilities (including to liquidity crisis) and reduced fiscal space.

Key characteristics and patterns of continent's public debt during 2003 – 2012 include a strong positive relationship between nominal public debt and GDP. This highlights

that those African countries with a greater capacity to contract debt (measured by GDP) have done so.

Figure 1. Pre- and post-crisis fiscal indicators



Source: Ncube and Brixiova (2013), 'Public Debt Sustainability in Africa: Building Resilience and Challenges Ahead', William Davidson Institute Working Paper No. 1053. Note: Results are medians for the world regions and averages for African-country groups.

How sustainable is Africa's public debt path?

The two main approaches to the debt sustainability are: (i) the approach of the International Monetary Fund and the World Bank, which looks at debt path projections and how they relate to thresholds; and (ii) the debt-stabilising primary balance approach, which looks for the primary balances to achieve a chosen debt path, given the assumptions about the evolution of the real interest rate and growth. We consider the sustainability of African debt dynamics using the debt-stabilising primary balance approach. This approach has the advantage of being relatively simple, transparent and having low data requirements.

“...the current African debt is the lowest in decades, with the fastest decline posted by the most indebted countries thanks to debt relief and accompanying prudent policies that made the relief possible.”

There is scope for debt management strategies to emphasise growth.

We look into what factors – growth, real interest rates, primary balance or other factors (including debt relief) – drove public debt changes in Africa and its groups. On the continent and in all groups, high growth and negative real interests contributed to decline in debt burden.

While growth played an important role across Africa, the negative interest rates helped lower debt especially in low-income countries (including fragile states), reflecting the concessional terms of their loans. In contrast, in frontier markets where governments often borrow on market terms – either on domestic markets as in Kenya, or on international bond markets as in Ghana and Namibia – the contribution of real interest to cutting the debt burden has been lower. Except for oil exporters, fiscal policies led to debt accumulation in all Africa's sub-groups. Finally, low-income countries saw their debt levels fall due to debt relief.

From our detailed analysis of African countries,² we find that in more than half of the countries studied the primary balance was above that required to keep the public debt-to-GDP ratio at its 2007 level. Taking this perspective would then suggest that fiscal stance of the majority of the countries in this group was sustainable at the end of 2012. Still, in some of these countries the public debt-to-GDP ratio was above 40%, pointing to a need for fiscal adjustment.³

African policymakers need to adopt appropriately sound fiscal policies and complementary monetary policies, while seizing opportunities for growth-enhancing investment, including through borrowing.

Policy discussion

Africa's public debt-to-GDP is lower today than it has been in decades and the overall fiscal policies are sustainable. The debt level is also comparable to other developing countries and below that of advanced economies. The debt-to-GDP ratio decline was to a large extent due to favourable differential between real interest rates and growth. In contrast, fiscal policy contributed to decline of debt only in oil exporting economies. At the same time, as oversubscriptions and favourable terms of Africa's sovereign bonds have shown, a number of countries have gained attention from international investors which has opened up their borrowing space.

There is, therefore, scope for debt management strategies to emphasise growth. For countries with borrowing space, this includes prudent borrowing for growth-enhancing outlays. The heightened interest of international investors combined with favourable terms has created a window of opportunity for African countries to embark on inclusive growth also through prudent borrowing, provided the funds are well utilised for growth-enhancing outlays. However, the interest-rate-to-growth differential is subject to shocks: while Africa's growth prospects are promising, the real interest is likely to be rising in the future. With the anaemic global recovery, some downside risks to growth remain, Africa's increased linkages with Southern partners notwithstanding.

In the framework utilised in this article, policymakers can reduce public debt-to-GDP ratio by:

- (i) accelerating growth;
- (ii) improving primary balances through revenue mobilisation and optimising of outlays;
- (iii) reducing the real interest (also by raising inflation), and
- (iv) defaulting.

Since inflation and defaulting undermine other goals that the government is likely to pursue (notably, rising living standards of the population and improved access to capital markets), we discuss growth and fiscal policies.

Given that the interest-rate-to-growth differential has been the main driver of prudent public debt dynamics in recent years, African countries may like to aim at high growth as a key element of their debt sustainability strategy. Even though Africa's growth recovery from the crisis' shock has been fast, growth rates remain below trend in a number of countries, suggesting space to grow. Further, for Africa to become a global growth pole in the next two to three decades and keep pace with rising populations, growth in most African countries needs to accelerate beyond the pre-crisis rates.

African policymakers need to adopt appropriately sound fiscal policies and complementary monetary policies, while seizing opportunities for growth-enhancing investment, including through borrowing. Caution should be exercised however when approaching commercial debt markets given the borrowing cost and possibility of shifting sentiments of investors. With low revenue-to-GDP ratios, many low-income African countries can reduce their debt through domestic revenue mobilisation. They would also benefit from greater efficiency of public expenditures and medium-term perspective in budgeting. Reducing inefficient spending (for example, over-sized wage bills in Southern Africa and costly energy subsidies in North Africa) would create space for pro-growth outlays (support to small- and medium-sized enterprises and investments in infrastructure and ICT) and discretion against shocks. In general, we can make the following distinctions around policies that appear prudent at this stage for ensuring long-term debt sustainability in Africa:

- Countries with high public debt and/or large fiscal deficits – Sudan among the oil exporters, Eritrea among fragile states, and Egypt, Ghana and Morocco among frontier markets – need to undertake fiscal adjustment. The scope and the speed should account for its likely impact on investment and growth, to avoid debt traps.
- In frontier markets with more developed financial systems and monetary policy space (for example, Cape Verde and Mauritius), the government could try to ease the impact of fiscal adjustment on growth via less tight monetary policy. Further, in some countries, especially those with long-term domestic debt, slightly higher domestic inflation could in theory help ‘inflate the debt away’, even though this option would have other negative implications.

Beyond these near-term policies, a number of structural and institutional changes and reforms will also enhance debt sustainability in African countries. Efforts to regain fiscal policy space and manage debt would benefit from macroeconomic policies based on fiscal rules and medium-term expenditure frameworks. Such frameworks would also help countries transition gradually to counter-cyclical and growth-supporting fiscal policies. In countries where rapid debt accumulation is of concern, ‘debt breaks’ could be also useful. Taking a long-term view, fiscal policy buffers are needed for emerging challenges such as creation of social protection schemes. African countries also need to strengthen their capacity to carry out independent debt sustainability analysis and apply it to their borrowing activities. Together with improved debt management capacity, such changes would allow frontier markets to access additional (non-concessional) funds, while maintaining fiscal sustainability.

Changes in the international financial institutions’ debt sustainability frameworks, and in particular better links between investment and growth, may be needed to reflect the phenomenon of ‘rising Africa’. A key question in this regard is: given the current high economic growth rates, lower risk premia, and lower global interest rates, what should be the new sustainable debt levels (and thresholds) in various African countries,

especially frontier markets? Besides changes to the debt sustainability frameworks, reaching the objectives of enhanced borrowing space and fiscal sustainability hinges critically on increased transparency and improved communication. While progress has been made, most countries could do much more in utilising technology for sharing information on key fiscal and macroeconomic developments. Similarly, communicating countries’ fiscal stance and changes to it early on (and delivering on the announcements) can help raise the credibility of fiscal policy.

This article has been condensed from Ncube and Brixiová (2013), ‘Public Debt Sustainability in Africa: Building Resilience and Challenges Ahead’, William Davidson Institute Working Paper No. 1053. The full working paper can be consulted for more detail on each of the debt sustainability issues discussed.

Notes

1. Kasekende, L., Brixiová, Z. and Ndikumana, L. 2010. Africa: Africa’s Counter-cyclical Response to the Crisis, *Journal of Globalization and Development*, Vol. 1(1).
2. For full discussion, see Ncube, and Brixiová, 2013.
3. In fiscal consolidation debates, 40% public debt-to-GDP ratio is often recommended as prudent limit that developing and emerging market countries should not exceed on a long-term basis.

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The post-2015 challenge for development: a new EIB instrument to take on riskier projects

As the post-Millennium Goals development agenda takes shape, the importance of ensuring adequate financing for development has been identified as a major issue. As UN Secretary General Ban Ki Moon said in August in his 500-day call to action, despite difficult budgetary circumstances the world must keep its financial promises.¹

Providing modern infrastructure services, through strategic investments, and facilitating access to finance are essential to generate growth and employment, reduce poverty and improve the living standards of the poor. Today these are the focus of our activity in developing countries. By helping to mobilise private sector resources for viable projects, we can help leverage taxpayers' resources to increase total investments materialised.

The European Investment Bank (EIB) – the EU Bank – has been active in Sub-Saharan Africa for more than fifty years, building up a wealth of experience. Our objective, as embedded in the EU's "Agenda for Change",² is to ensure that aid and investment in development are

increasingly channelled where they are most effective and can provide measurable and sustainable long-term impacts.

We are pursuing this objective through an increased combination of our resources with aid – the loan-grant "blending" approach – to address market failures, target policy goals (e.g. access to infrastructure and financial services, notably for the poor) and strengthen knowledge transfer and capacity building through technical assistance.

When it comes to investing in Africa, the issue of risk is pervasive. The appetite for investment on the continent is growing, but in order to sustain this momentum,

measures towards mitigating the many aspects of risk, real or perceived, are essential. This is why we are working closely with the European Commission and other financing institutions to examine how the multiplier effect of 'blending' to lend and invest in Africa, could be strengthened, by further catalysing private sector resources.

In Africa, the traditional conduit for EIB activity has been the Cotonou Investment Facility, established in 2003.³ It has so far provided over €4 billion in funding for well over 200 projects. Under this Facility, we have supported local entrepreneurs and smaller projects through mutually beneficial partnerships with local banks, microfinance institutions and private equity funds. Our engagement across African countries has helped strengthen the local financial sector both technically and financially and ultimately contributed to better access to finance. One such example is the Private Enterprise Finance Facility in East Africa,⁴ where we work with approximately 20 intermediaries supporting SMEs and microfinance.

We have also transferred the knowledge gained from our activity in Europe to infrastructure investments in energy, water, transport and telecommunications that have delivered national benefits, and also improved regional cooperation. Recent flagship projects include the 30 MW Cape Verde Wind Power project, the modernisation of air traffic security with ASECNA, a regional body covering 17 sub-Saharan countries, as well as sub-Saharan Africa's largest renewable energy project to date - the 300 MW Lake Turkana Wind Farm in northern Kenya.

Indeed, economic concerns are challenging public and private investment in most countries and the European Investment Bank is increasingly called upon to reinforce its role. The track record and wide experience demonstrated by the Bank's support for projects around the world has helped address investment gaps, improve the business environment through better infrastructure and ensure more fruitful and effective cooperation with other sources of finance in African states.

But now we want to go further. A new half billion euro endowment – the 'Impact Financing Envelope' - under the Facility, will notably allow us to step up our engagement in the private sector in riskier areas (e.g. agriculture) and more difficult countries (e.g. fragile states) and towards under-served segments of the population. Impact financing will thus support projects with higher development impact whilst bearing the higher risks. One avenue currently being explored is investment in Social Impact Funds.

In the infrastructure sector, investment in energy – widely recognised as a key element to unlock economic growth in Africa – is one of our top priorities. We are working closely with the European Commission on a coordinated EU response to the UN's Sustainable Energy for All Initiative,⁵ involving the development of innovative financing instruments for catalysing private sector investment into renewable energy, energy efficiency and access to energy.

Looking ahead, we intend to scale up our lending under the Investment Facility to increase the promotion of private sector investment, including public private partnerships for infrastructure. We will also increasingly draw on the experience we have gained across different European markets to deploy innovative financial instruments which stimulate economic and social development through the projects we support, thus effectively reducing poverty.

The Cotonou Investment Facility has been recognised as a unique risk-bearing instrument to finance higher-risk investment in support of private sector development. To date, it has enabled the re-cycling of scarce EU funds, and is reaching the initial aim of becoming a self-sustainable instrument. The new Impact Financing Envelope ensures that the EIB can continue to make a valuable contribution to the post-2015 development agenda.

Notes

1. www.un.org/sg/statements/index.asp?nid=7930
2. http://ec.europa.eu/europeaid/policies/european-development-policy/agenda-change_en
3. www.eib.org/projects/regions/acp/funding-and-financial-instruments/investment-facility/index.htm
4. www.eib.org/projects/pipeline/2012/20120317.htm
5. www.se4all.org/



Werner Hoyer is President of the European Investment Bank.



Maximising the ‘Beyond Aid’ approach: Mobilising domestic financial resources for Africa’s transformation

Africa’s growth in the first decade of the new millennium propels the aspiration that the continent could serve as a growth pole for global prosperity and the next investment frontier. Undoubtedly, Africa is rising as a result of the decade old impact of transformative factors including deep-seated policy reforms in political and socio-economic governance. This has, in turn, enabled many African countries to experience higher growth rates, lifting Africa out of an era of Afro-pessimism to a new epoch of Afro-enthusiasm, accompanied by an amazing shift in demographic profiles, rapid urbanisation, a strong voice of the continent’s civil society and consensual policy measures towards sustainable development.

However, for the continent to fully realise its growth potentials, it must frontally address the development finance constraint of continued dependence on external aid. Official Development Assistance (ODA) is falling well short of commitments and is largely unfulfilled. Many development partners have cut back on ODA. In 2011, aid flows declined in real terms for the first time in many years. To thrust African economies into the middle-income class, the consolidated flow of a significant amount of domestic financial resources at national, regional and continental levels is required.

Fifty years plus of political independence and many African countries are still largely dependent on external resources for public finance and domestic investment. A fully sovereign Africa should exude self-reliance and value-driven partnership, not dependence. Africa must now look more purposefully and decisively inwards to raise extra resources for stable growth and effective development. There is a dire need to break with the past.

Fundamentals and enabling environment in mobilising domestic financial resources in Africa

The macro-economic fundamentals exist for the continent to raise more financial resources domestically to fund its own development, including:

- Africa generates over US\$520 billion annually from domestic taxes. Public pension fund assets are growing impressively while more than US\$168 billion annually is earned from minerals and mineral fuels; with an estimated US\$400 billion held in international reserves by Central Banks.
- Diaspora remittances climbed to US\$40 billion in 2012 and have the potential to increase through securitisation.
- Stock Market Capitalisation in Africa rose from US\$300 billion in 1996 to US\$1.2 trillion in 2007. Banking revenues are estimated at about US\$60 billion with over 10 African countries today having established Sovereign Wealth and Stabilization Funds and Private Equity Market is worth about US\$30 billion.
- Illicit financial flows (IFF) from the continent reached US\$854 billion over the period between 1970 and 2008. To stem IFF, policy options include raising awareness among African policy makers and stakeholders; developing national/regional institutional frameworks to improve greater transparency and accountability; and engaging international counterparts to strengthen global regulatory frameworks. If curtailed, more financial resources will be available for the implementation of national and regional development programmes and projects.

Economic growth is a pre-requisite for wealth creation and Africa is making respectable progress with many countries ranking high among the world's fastest growing economies. To sustain current growth rate and step up to double-digit annual GDP growth rate for the next

“A fully sovereign Africa should exude self-reliance and value-driven partnership, not dependence.”

two decades, Africa needs to increase investments in socio-economic infrastructure, human resources and harness the emerging demographic dividend. Overall, Africa has embraced the best means to promote enabling legal, policy and regulatory environment to promote transformation.

Tax revenue and tax administration: Africa has good potential to raise more domestic resources from efficient tax administration systems, by broadening the tax base rather than increasing taxes and tapping relatively underutilised sources of taxation such as property and environmental taxes. The excessive granting of tax exemptions, particularly for Multinational Corporations (MNCs) engaged in extractive activities, must also be revisited both to increase available tax revenues and improve perceptions of fairness of tax systems. Improved tax collection must be coupled with measures to ensure that new government revenue is used for the benefit of the citizens through social expenditures and development projects. The average tax to GDP ratio in Africa is higher than that in other regions. Over the period 2005-2010, the ratio was 20% compared to 15% in high income countries, 13% in middle income countries and 11% for East Asia and the Pacific. Though many African countries have ratio that are less than 10%.

Development finance in Africa (US\$ billions)

Type of Development Finance	2002	2007	2011
Domestic revenue	141.6	403.4	520.1
Private flows	13.9	65.4	59.2
ODA	20.4	38.9	50.0
Remittances	13.2	37.0	41.6

Source: ECA and OECD 2012

Domestic financing instruments - impetus for transformation

Major viable instruments and financial intermediary arrangements are listed below:¹

- Establishment of *specialised funds for Africa's infrastructure development*, notably the *Africa 50 under the auspices* of the African Development Bank (AfDB) to promote regional and transformative infrastructure projects. The *Africa50* is now matured into a specialised investment vehicle designed to significantly narrow the infrastructure finance gap, with a proposed initial Project Finance Business Line of up to US\$500 million and a contribution of up to US\$100 million to *Africa50's* Project Development Business Line.²

2. Setup of an *African Credit Guarantee Facility (ACGF)* as a credit enhancement mechanism to support financing of development projects. ACGF could provide guarantees on bonds issued by special purpose vehicles to raise finance projects of transformative nature. ACGF will underwrite Public-Private Partnerships and less than investment grade private companies that would otherwise have difficulty in raising long-term finance from both local and international capital markets. The Facility will bolster the confidence of investors in Diaspora bonds, private equity funds with African origin, investment of pension funds and the use of international reserves of central banks as well as improve credit rating for bond issuers and lower interest payable. ACGF's bond guarantee operations will enable African companies to access bond markets, expand and diversify their sources of debt capital.
 3. Deepening *Africa's bonds markets* - The short-term maturity of loans offered by the banking sector is not suitable for financing long-term investments. Hence, deepening viable and vibrant bond markets is critical. Issuance of Infrastructure Bonds could raise long-term finance for infrastructure development. A growing phenomenon with varying degrees of success recorded already in Ethiopia, Kenya, Nigeria and South Africa. To make Africa's bonds markets work, attention should be paid to superior returns on bond coupons held by investors; low borrowing cost; and tax-exempt status for returns from investment on infrastructure bonds.
 4. Likewise, *issuance of diaspora bonds* as debt instruments by governments to raise development finance from its diaspora communities is a viable alternative to borrowing from the international capital market, multilateral development finance institutions (DFIs) or securing bilateral loans. From the early 1930s, Japan and China, Israel and India have recorded successful diaspora bonds issuance. With the rising importance of Africa's Diaspora, the AU in 2007 pronounced Africa's Diaspora as the 6th Region of the continent and the African Diaspora remitted over US\$40 billion in 2010. Over US\$3 billion annually could be mobilised from such Diaspora funds. *Securitisation of remittances* from Africa's Diaspora provides another valuable source of development finance essentially as long-term funding through the sale of assets to a special purpose vehicle (SPV) that then incurs debt secured (remittance-backed bonds) by the assets, which are collateralised by the future income stream. Remittance-backed bonds have been performing very well and global rating agencies note that these bonds outperform their rating class and will continue to perform well even during global credit crises.
 5. With over 10 African countries establishing sovereign wealth or stabilisation funds, the surpluses from natural resources are being harnessed and converted into sovereign wealth for developmental uses or even for future generations. *Strategic Development Sovereign Wealth Fund (SDSWF)* is utilised to promote national economic or development goals. It is commonly accepted that most sovereign funds have a commercial objective which is to earn a positive risk-adjusted return on their pool of assets. SDSWF is targeted at sole utilisation of promoting national economic or development goals.
 6. *Regional stock exchanges* offer African countries the appropriate mechanisms to mobilise long-term capital for development. The economic benefits of fully functional regional capital markets will change Africa's financial landscape and make available additional investment funds from internal sources. Major benefits include low cost of borrowing, liquidity, reduced cost of financial transactions, risk transfer and improved corporate governance. Africa needs to promote more regional stock exchanges such as the BRVM - an electronic stock exchange for eight West African countries headquartered in Abidjan, Côte d'Ivoire, which commenced activities in September 1998. Such initiatives help to address the stock market characteristics of relatively small capitalisation and liquidity. Harnessing capital from national and global investors through fully functional regional exchanges will provide access to cheaper sources of long term finance; opportunity for improved management of financial risks and diversification; improved capital allocation; savings mobilisation; and improved corporate governance.
 7. New financing models for *Public-Private Partnerships* will add more impetus to bridging the fiscal gap through an infusion of private capital and improve timeliness of delivery of goods and services, and provide better value for money. Key features of the new PPP models include: a) replacing private sector equity, wholly or in part, by some form of concessional equity or subordinated debt, thus allowing for a cheaper cost for the end user; b) creating reliable refinancing process through which key debt providers have the opportunity to reduce or remove their exposure to the project after completion; c) enabling domestic or diaspora investors to invest in long term, low risk and stable domestic infrastructure assets through properly structured project bonds; d) structuring project bonds through "re-financing vehicles" set up for instance by Sovereign Funds supported by DFIs.
- Furthermore, *promotion of African-owned private equity funds (PEFs)* will help in mobilising own financial resources including pension funds. However, with PEF being a new form of investment on the continent, it requires new forms of regulation, and the enabling environment needs to be developed.

The evolving role of NEPAD

NEPAD, as an African Union (AU) strategic initiative, is championing the policy adoption of the effective mobilisation and utilisation of Africa's financial resources for its development. NEPAD is changing steadily after long concentration on traditional external public investment schemes for its programmes and projects, a trend which is creating dependency on partner funding. Today, the NEPAD Agency has adopted the Domestic Resource Innovation Mechanism (DRIM) as a strategy

Africa can finance its development from its own domestic financial resources, if innovative instruments are deployed and supported by appropriate means of implementation.

to mobilise and use AU Member States funding for programme development and implementation. This is in the spirit of Africa regaining full ownership and leadership to impact on the realisation of the continent's development agenda. Equally, the Agency has embraced major initiatives, namely: the National Agricultural and Food Security Investment Plans (NAFSIPs) under Comprehensive Africa Agriculture Development Programme (CAADP); the African Fisheries Impact Investment Fund and the Dakar Agenda for Action (DAA) on Africa's Infrastructure Financing through the Programme for Infrastructure Development in Africa (PIDA). These initiatives form part of the implementation model to accelerate the NEPAD transformation agenda.

Overall, the African Union is exerting concerted efforts to reduce aid dependency by promoting the *Alternative Sources of Financing the Union* which seeks to address the challenge of inadequate funding of AU development programmes and projects, whereby about 90% of funds for continental projects come from external development partners. Equally, another policy initiative in the beyond aid approach is the Illicit Financial Flows being promoted through the African Ministers of Finance, Economic and Planning.

Breaking with the past

To maximise the beyond aid approach, African governments and institutions should build sustained progress in regional integration, policy coherence, good governance and institutional reforms with underlined emphasis in Capacity Development to leverage DRM. This will help bolster the renewed drive for industrialisation in Africa.

ODA has helped, but will not deliver sustainable growth and development in Africa. It is acknowledged that aid continues to play a role in development financing in the short to medium term. However, African governments and regional institutions are intensifying efforts to enhance domestic resource mobilisation and reduce the reliance on aid in the long run.³ ODA, in the short term, can serve as a catalyst to develop DRM mechanisms in Africa. The continent has the resource base to support the development and implementation of these domestic finance instruments. Africa's emerging status has today become increasingly attractive to new key partners in the global economy, especially Southern emerging economies. At the global level, NEPAD plays a significant role in pushing the African agenda within the auspices of the Global Partnership (GP) for Effective Development Cooperation, whereby the inter-connections between financing for development, South-South Cooperation and Capacity Development are promoted.

Africa can finance its development from its own domestic financial resources, if innovative instruments are deployed and supported by appropriate means of implementation. In fact, a number of African countries have taken this route of intensifying policy reforms in raising additional domestic financial resources for development projects.

With strong and sustained commitment to good governance, effective institutions and a responsive policy framework, enhanced awareness and involvement of the continent's stakeholders, especially the private sector, and heightened consciousness of the need among Africans for Africa to own its development, the continent can define a new robust threshold for domestic resources that will enable the implementation of at least 70-80% of its development programmes and projects.

Africa is taking advantage of its development opportunities by looking within. The continent must now break with the past. The AU Agenda 2063 and Post 2015 Development Agenda must take into full consideration the passion and political determination and the potential capacity to make aid history!

This article draws largely from the NEPAD-UNECA study report on 'Mobilizing domestic financial resources for implementing NEPAD national and regional programmes and projects – Africa looks within' (2014). The study was undertaken in collaboration with UNDP, African Development Bank and UNCTAD under the guidance of the NEPAD Heads of State and Government Orientation Committee (HSGOC).

Notes

1. NEPAD-ECA study report, 2014.
2. Dakar Agenda for Action on Africa's Infrastructure Financing, June 2014.
3. African Consensus and Position on Development Effectiveness (2011) issued under the Africa Platform for Development Effectiveness (APDev) which is coordinated jointly by AUC and NEPAD Agency.



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More and better financing for development

There is plenty of money in the world that could be used for development. Just stopping the enormous sums illegally flowing out of developing countries could provide billions of dollars for poverty reduction. Redirecting fossil fuel subsidies to renewable sources of energy would reduce the pace of climate change and more than double investments in green energy. Every child would be enrolled in school and teachers celebrated as heroes if peace entrepreneurs were able to mobilise as much money as war entrepreneurs. Money can be allocated and used much more effectively if we choose to do so.

Poverty has been cut by half and millions of lives have been saved since the world mobilised around the Millennium Development Goals. As these goals expire in 2015, world leaders will gather at the United Nations (UN) to agree on a new set of sustainable development goals covering areas such as poverty reduction, education, health, equality and the environment. Whatever the goals, political leadership, policies that work and financial resources will be needed to implement them.

Making the right political decisions is of utmost importance. All the amazing success stories of recent decades have emerged from countries making the right political decisions. The Asian economic miracles did not happen because of a great new invention, discoveries of valuable natural resources or conquests. They were made possible by leaders who made good political decisions. Deng Xiaoping took the People's Republic of China in a new direction, which eventually brought 600 million people out of poverty. Korea made smart choices

that took it from being one of the poorest countries in the world to one of the richest. Brazil would have continued down the road of ever worsening inequalities had President Lula and the reformists not demanded equality through minimum wages, cash transfer programmes for the poor and better public services. Indonesia, Malaysia and Singapore provide other inspiring examples of leadership.

Implementing policies that work in various sectors and learning from each other are keys to success. Take the cases of Vietnam and Ethiopia. In Vietnam, high school students do better than the average student in much richer OECD countries. How has Vietnam achieved this? By prioritising teachers. Ethiopia has reduced child mortality by two-thirds over two decades. How? By training thousands of health workers and deploying them across the country. We should all learn from these successes and do more of what works.

“Poverty has been cut by half and millions of lives have been saved since the world mobilised around the Millennium Development Goals.”

But it is not only a question of making the right political decisions. Reducing extreme poverty – and poverty at large – and driving economic growth in an inclusive and planet-friendly way will require a great deal of money. How to mobilise the necessary resources to tackle the challenges of the post-2015 sustainable development goals?

The world is changing and so must development co-operation

Official development assistance (ODA) has been a tremendous success. We need more of it! A new world record of US\$135 billion in development assistance was reached in 2013, debunking the myth that development will be put on the backburner because of economic stress. The next time you hear a minister, ambassador, development worker or journalist say that development assistance is decreasing, please tell them that this is not true. ODA is increasing, and it has never been higher. The United Kingdom fulfilled, for the first time, the international target of giving 0.7% of national income as development assistance. Turkey managed the biggest jump in foreign development co-operation spending in all of Europe – a 30% increase. Japan's development co-operation also increased substantially. The United Arab Emirates set a new world record in generosity by spending 1.25% of its national income on development assistance.

Yet the geography of poverty is changing. Poor people used to live in poor countries, but today there are 1 billion extremely poor people living in middle-income countries such as India and Nigeria. While the relative importance of ODA compared to private investments is decreasing in these countries, by becoming smarter – mobilising greater private flows by mitigating risk, leveraging private investment and facilitating trade – it can continue to contribute to reducing poverty, wherever it exists.

Despite this changing geography of poverty however, it is in many of the poorest and most fragile states that least progress is made. Within five years, most extremely poor people will be living in fragile states. ODA remains of vital importance to the least developed countries and fragile states because they have limited capacity to access other forms of financing, for instance to fund infrastructure, basic health services and education. Yet many of these countries still do not receive enough external support, and are even faced with declining assistance. Providers of development co-operation must find a way to increase assistance to these countries. The existing UN target of providing 0.15-0.20% of national income to the least developed countries is difficult to reach for providers whose total ODA budgets are less than this. A different

target, for example of 50% of ODA directed to the poorest and most fragile countries, might make more sense.

In addition, there are many more resources available beyond ODA that can finance the sustainable development goals. Southern providers of development co-operation are increasingly important. China is now an important provider of development assistance and accounts for 20% of all foreign direct investment in developing countries. Turkey's development programme is ambitious and expanding – it has the greatest presence on the ground in Somalia and has been incredibly generous to Syrian refugees. Arab nations are becoming world leaders in generosity towards others. Brazil and Mexico use their resources and their own development experience to assist Latin American neighbours. Foundations are also important players – the Bill & Melinda Gates Foundation now provides more money for development than many large European countries.

The way we measure and define development co-operation in the future should reflect the changing world in which we live (see Box). ODA as a metric has served us well, but we need a measure that will take account of the broader financial flows for development and encourage smarter development co-operation – one that supports closer co-operation between new and old providers of development finance. This new metric will complement the ODA measure, not replace it.

Countries are in charge of their own development

Countries must be in charge of their own development priorities. Used “smartly”, development assistance can help them maximise the available public and private sources of development finance. Countries' own domestic resources, such as taxes, are the most important source of revenue, even in the poorest countries. The OECD has rolled out two programmes – Tax for Development and Tax Inspectors without Borders – to improve tax revenue generation. A project assisting Kenya's tax administration returned an incredible US\$1,650 for every US dollar invested. Foreign direct investments are much needed to build roads, ports and railways, and to create jobs. Development assistance can help unleash private investment and improve the investment climate. At US\$351 billion in 2012, the flow of remittances sent home to developing countries by migrant workers was higher than development assistance and foreign direct investment combined. In fact, this is by far the largest source of external finance for many countries. Yet charges for sending remittances home are as much as 10%, adding up to US\$35 billion a year in transaction fees.

The OECD DAC's work on new measures of development finance

The main objective of modernising the DAC's development finance framework is to adapt to today's realities of global development finance. This includes capturing new financial instruments and providers, better valuing donor effort and recipient perspectives, and ensuring that incentives promote the most efficient uses of financial resources. Another objective is to strengthen the credibility of the system by addressing growing criticism of the ODA measure over the past decade, including members' differing reporting practices on how to calculate the subsidy component of ODA loans, which have cast doubt on ODA as a reliable indicator of donor effort.

Work up to now has focused on:

- investigating a shift from recording net financial flows as ODA to scoring only the grant element (concessional or subsidy component) of loans and other financial instruments as ODA, as opposed to their full face value;
- using a more appropriate discount rate for calculating the grant element (as opposed to the current 10% rate); this would align with prevailing financial market conditions;
- examining how to standardise the reporting of "in-donor" components of ODA (i.e. expenditures in the providers' own countries, such as first-year refugee costs, administrative costs, student costs) to improve their legitimacy, transparency and comparability, thereby addressing criticisms of "phantom ODA" (i.e. ODA that does not flow to developing countries);
- looking at how to channel an increased share of ODA to the countries most in need, to counter the trend of declining ODA levels to least developed countries.

Work is in progress at the World Bank to halve these transfer costs – which would mobilise billions and make a huge difference in people's lives.

Developing countries are also losing billions of dollars every year to corruption, money laundering and tax evasion. These billions fund crime and lavish lifestyles rather than schools and hospitals. Outward or lost flows like these can be stopped by sharing information, streamlining regulations and improving the capacity to investigate and prosecute financial criminals in developed and developing countries alike.

Green finance is development finance

All green investments are good for development. There are 1.3 billion people in the world without access to electricity. Any investment in renewable energy in a developing country would add to existing electricity production capacity while also stimulating development. Climate adaptation measures make sense for development too. Managing rivers and controlling floods saves lives and money. The right decisions can mean that the human and economic costs of floods, cyclones and other extreme weather events can be reduced, even as climate change exacerbates the frequency and size of these events. For example, the monsoon floods that killed hundreds of thousands in Bangladesh a few decades ago would have caused much fewer casualties today, as the government's ability to evacuate people and control infectious diseases has improved.

It is indeed possible to protect the environment while reducing poverty and developing strong economies. Brazil has reduced deforestation in the Amazon by 80% alongside rapid economic growth. Ethiopia aims to become a middle-income country without increasing its greenhouse gas emissions. If they can do it, others can too.

There are many sources of financing available to eradicate poverty and spur sustainable growth. All we have to do is grab them.

This article will feature as the DAC Chair's Editorial for the OECD Development Co-operation Report 2014: Mobilising Resources for Sustainable Development. For more information on the report, please visit: www.oecd.org/dac/dcr2014



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Financing a transformative post-2015 agenda: where are the current discussions taking us?



The financing for development conference in Addis Ababa in July 2015 is expected to agree a finance for development framework to implement the post-2015 development agenda (the Sustainable Development Goals - SDGs), an agenda which itself is undergoing major discussions in the coming year. The European Report on Development (ERD) 2014¹ entitled 'Financing and other means of implementation in the post-2015 context', and implemented by Overseas Development Institute (ODI), ECDPM, DIE (German Development Institute), University of Athens and Southern Voice, is focused on exactly this theme. The report is scheduled to be launched at the end of the year. What have we learned so far from a series of consultations² organised by partners in developing countries and Athens consultation³ on infrastructure finance? And how does this relate to past and other, current discussions on finance for development? This article highlights a few issues that have come to our attention and does not intend to give the full breadth of issues under discussion.

What new issues require further reflection?

Financing for development is not a new issue, having discussed these issues as part of the 2002 Monterrey Conference for Development. However, a range of new issues concerning financing and implementation have emerged in the current discussions which were not fully addressed in the implementation that followed the Millennium Development Goals (MDGs). The MDG process approached implementation largely from a financing gaps perspective. Crudely speaking, a financing gap would be identified, and as long as aid was increased to fill this gap, poor countries would achieve the social progress embodied in the MDGs. Estimating financing gaps for the MDGs therefore aimed, successfully, at boosting the level of (developed country) aid to developing countries.

This approach to financing and implementation requires updating from a range of perspectives. First of all, the *finance landscape has become more complex*. There may still be an important role for public finance (especially domestic public revenues) in development, but its role seems to be evolving, as we consider the role of private sector flows and instruments as countries develop; aid is still regarded as an important resource, yet in a supportive and catalytic role rather than only in a delivery role; furthermore, remittances, South-South development co-operation and international capital flows such as bond inflows have risen relatively fast in the poorest countries. Thus a range of financing sources, both public and private, national and international, will be important for development, as is argued in the Intergovernmental Committee on Financing for Development report⁴ which was released this August.

We therefore need to examine the respective roles of different types of flows in different types of countries.

Secondly, the *context of finance matters* for i) how much finance is needed, ii) the impact of finance and iii) how much finance is mobilised. For example, the World Bank⁵ argues that the cost of achieving any development goal depends on the efficiency with which the goal is pursued. They estimate the undersupply of infrastructure in developing economies at US\$1 trillion per year until 2020, with an additional US\$200 to US\$300 billion per year to ensure green infrastructure; but these costs could be reduced by making more efficient use of existing infrastructure and by improving quality and management. McKinsey & Co.⁶ argue that countries could reach a 60% improvement in infrastructure productivity (or US\$1 trillion annual saving) through the scaling-up of good practice and making better use of existing infrastructure. As the policy environment can therefore contribute both to the mobilisation of finance and more effective use of financing, policy coherence for development is essential.

Finally, with the SDGs there is also a shift in the discussions towards the need for transformative sustainable development, reflected to some extent in the report of the Open Working Group on the Sustainable Development Goals.⁷ This requires a shift from the MDGs approach focused on social development in developing countries, to a sustainable development transformational approach which balances reductions in inequality and poverty, with productivity and employment increases and lower CO2 emissions and better natural resource management in developed and developing countries – that is a balance of economic, social and environmental objectives to promote a universal and transformative

agenda. This is not a short term agenda where aid can quickly fill gaps, but a long term agenda, which the ERD 2014 will be examining in greater detail.

And what important considerations can we learn from country consultations?

The ERD 2014 has commissioned studies from and has held consultations in six countries (Bangladesh, Ecuador, Indonesia, Mauritius, Moldova and Tanzania), which *inter alia* are asked to provide empirical evidence on the role of different finance flows and the importance of policy context. Here we discuss lessons from just two, Tanzania and Mauritius.

The Tanzania ERD consultation for example focused on energy transformation, an area in which the government aims to promote access to modern energy sources and promote the role of renewable energy. The consultation highlighted that the development agenda should also touch on the economic and environmental aspects of development, a step in complexity from the MDGs which limited itself mainly to the social aspects. The discussions were about making a range of finance flows work for energy transformation. The consultation for example focused on the interest from the Tanzanian domestic private sector in developing renewable energy projects, with financing also planned from South-South flows, pension funds and development finance institutions, as well as aid grants. For example, a 100MW US\$536 million geothermal project funded by the Climate Investment Funds is currently being developed, with support from the Government of Tanzania and loan contributions from the African Development Bank and commercial banks; also a 100MW wind farm is

“ There may still be an important role for public finance in development, but its role seems to be evolving, as we consider the role of private sector flows and instruments as countries develop.”

under development, using financing from domestic private sector actors, international firms and development finance institutions. In addition to relevance of finance, it is clear that the domestic policy context matters. Progress in renewable energy development seems to be hampered by a number of policy bottlenecks, including the presence of bureaucratic delays and the lack of appropriate price guarantees on renewable energy technologies. Thus finance needs to be complemented by other means of implementation to facilitate an energy transformation. The ERD 2014 aims to examine the relevance of context for finance in greater detail.

The discussions in Mauritius suggested structural transformation policies were made possible by establishing effective state-business relations that sought consensus on the direction of the economy, and shifted the economy from a monocrop sugar economy in the 1960s and 1970s into a diversified manufacturing, services and business economy. The share of agriculture fell from 25% of GDP in 1968 to 3.5% in 2013. Establishing a conducive policy framework also attracted finance. During the restructuring process sugar rents were directed to developing the garment and tourism industry promoting further diversification of the economy through private investment in industry and public investment in infrastructure. While comparatively small, aid was important as it facilitated the transformation by compensating the 'losers' of the restructuring process. The Mauritius illustration also shows that transformation is a never-ending story. With economic stagnation in 2005, the government shifted its focus to boosting job creation and economic growth through the ICT and financial services sector. This

included bringing down connection costs and improving labour force skills. The contribution of ICT to GDP therefore grew from 4.1% in 2000 to 6.5% in 2010. Now, the search is on for appropriate instruments to attract private finance for infrastructure, as public finance is capped, and promote the role of public-private partnerships in sustaining transformation.

A research agenda for ERD

Financing for development is a complex issue. In order to move forward, a broader agenda needs to be adopted which examines the effects of different finance flows and the importance of complementary policies and institutions in mobilising and using finance effectively for sustainable development transformation, a long term transformative agenda combining economic, social and environmental objectives. The ERD 2014 report will aim to examine these issues and provide suggestions for the financing for development framework. Stay tuned!

Further information on the European Report on Development can be found at <http://www.erd-report.eu/>

Notes

1. <http://www.odi.org/projects/2742-erd-2014-european-report-development-financing-post-2015>
2. <http://post2015.org/2014/05/08/european-report-on-development-2014-country-illustration-workshops/>
3. <http://www.odi.org/events/3963-financing-transformative-post-2015-agenda-does-infrastructure-finance-fit>
4. <http://sustainabledevelopment.un.org/content/documents/4588FINALREPORTICESDF.pdf>
5. <http://www.worldbank.org/content/dam/Worldbank/document/Poverty%20documents/WB-PREM%20financing-for->

development-pub-10-11-13web.pdf

6. http://www.mckinsey.com/insights/engineering_construction/infrastructure_productivity
7. http://sustainabledevelopment.un.org/content/documents/4518SDGs_FINAL_Proposal_of_OWG_19_July_at_1320hrsver3.pdf



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“A broader agenda needs to be adopted which examines the effects of different finance flows and the importance of complementary policies and institutions in mobilising and using finance effectively for sustainable development transformation.”



How to harness the global capital markets for the Sustainable Development Goals

The purpose of this article, and the full report¹ on which it is based, is to provide those involved in policy making with specific suggestions as to how they can move the capital markets onto a more sustainable basis. Adopting the conventional definition of sustainable development, we are seeking to promote: capital markets that finance development that meets the need of the present, without compromising the ability of future generations to meet their own needs.² This is an important concept for investors as development that provides short term benefits but creates significant costs over the long term can reduce the absolute value of long term investment portfolios.

Public policy makers have traditionally tended to focus on the flow of aid when considering traditional sustainable development issues. However, we believe that considering how the hundreds of trillions of private capital are allocated matters far more than how the tens of billions of dollars of official assistance get dispensed.

We see the primary failure of the capital markets in relation to sustainable development as one of misallocation of capital. This, in turn, is a result of global governments' failure to properly internalise environmental and social costs into companies' profit and loss statements. As a consequence, the capital markets do not incorporate companies' full social and environmental costs. Indeed, until these market failures are corrected through government intervention of some kind, it would be irrational for investors to incorporate such costs since they do not affect financial figures and appear on the balance sheet or – therefore - affect companies' profitability. This means that corporate cost of capital does not reflect the sustainability of the firm. The consequences of this are that unsustainable companies have a lower cost of capital than they should and so are more likely to be financed than sustainable companies.

We believe that policy makers need to both change the pricing signals within the market and improve the readiness of the supply chain of capital to integrate sustainability issues. This involves moving all participants towards a longer-term perspective when investing and exerting their influence as company owners. This requires an understanding of the role of institutions at each stage of the capital supply chain and a clear vision of how this stage should integrate sustainability issues within its operations. Put simply, policy makers need to improve the profitability of sustainable businesses relative to unsustainable ones. They also need to improve the ability of all key market participants to integrate these signals. We provide a few suggestions as to how this can be achieved.

The structure of capital markets

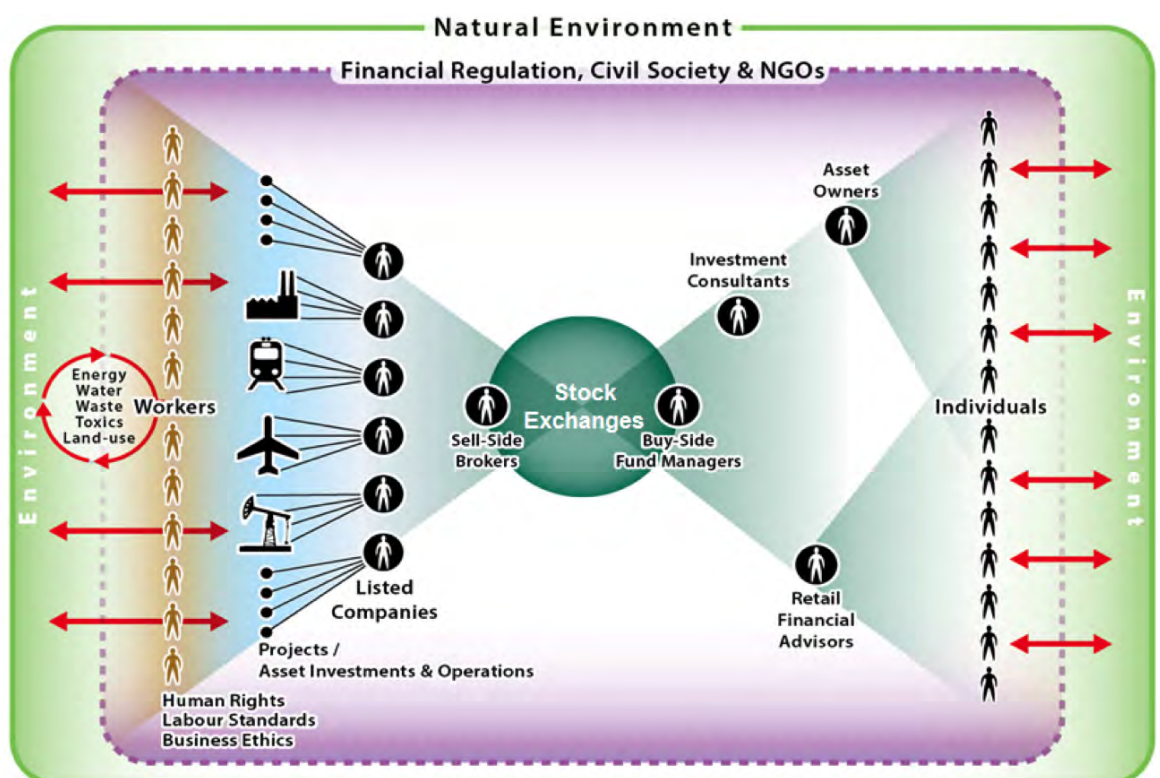
To help picture the capital markets, consider Figure 1. This depicts the relationship between the financial institutions that operate the market between the demand for and supply of capital in the equity markets. The different roles of the financial institutions are important as each role reflects the nature of the influence.

Figure 1 is a simplifying model of the equity capital market and is intended to demonstrate how the various capital market institutions relate to each other. Put simply, money flows from the individuals on the right hand side into companies on the left hand side, which put the capital to work in different ways to generate a return on investment for their shareholders. These individuals may invest alongside others as institutional investors - such as pension schemes, insurance companies, or sovereign wealth funds – or as individual investors through retail financial advisors.

In many developed markets, institutional asset owners take the advice of investment consultants who, in turn, recommend which asset manager to choose. Such asset managers are also referred to as buy-side fund managers, and they buy shares from brokers on stock exchanges. Sell-side brokers are typically part of an investment bank. Such brokers provide investment analysis and recommendations to fund managers. They also act as market intermediaries, helping those fund managers that want to buy and sell securities. Some brokers will also be the prime broker for a company. Where this is the case, they will also advise the company on their capital structure and underwrite the issuance of new equities to the market.

Corporate debt is also traded in a similar way, although it tends to be conducted between fund managers and brokers, without the use of stock exchanges.

Figure 1: The structure of the equity capital market



‘ ...considering how the hundreds of trillions of private capital are allocated matters far more than how the tens of billions of dollars of official assistance get dispensed.’

Of course, while company workers are highlighted as working for companies, they are also in many cases the providers of capital. So, in this sense the flow of capital can be thought of as circular.

Towards SDGs that secure capital market support

Our specific Sustainable Development Goals (SDG) proposals are based on our analysis of the structural weaknesses in the capital markets described above, and are presented below according to the relevant thematic areas used by the SDGs Open Working Group³ and are as follows:

“Goal: A resilient, sustainable economy that optimises quality of life for all”

Targets: Economic growth

- Develop SDG capital raising plans: for all Governments to develop national capital raising plans covering how they intend to finance the delivery of a zero-carbon economy and the Sustainable Development Goals; and for these national plans to be coordinated at the international level by the UN and World Bank. These will include a view on the money that can be raised via infrastructure investment, project finance, corporate debt, foreign direct investment, equity investment and sovereign and Multilateral Development Banks debt (see Figure 1);
- Establish integrated incentives: Governments to promote financial incentives along the investment chain that are fully aligned with long-term sustainable performance. This could involve reshaping the structure of individual remuneration along the capital supply chain;
- Promote integrated financial regulation: Governments to promote capital markets regulation that integrates sustainable development factors in the mandates of the supervision agencies of stewardship codes, listing rules and financial stability;⁴

“Sustainable Consumption and Production (of financial services)”

- Improve integrated financial literacy of the consumers and producers of financial services: Governments to have integrated sustainable finance into their national curricula by 2020; for the top fund manager and analyst courses such as the Chartered Financial Analyst Institute⁵ and for all the top MBA programmes to cover sustainable finance;
- Ensure integrated asset ownership: Governments to ensure all asset owners⁶ with more than US\$1 billion under management publish a report to the beneficial owners and society on how they have integrated sustainability considerations into their investment management agreements, or to explain why they have not done so;
- Ensure integrated investment consulting: Governments to require all investment consultants advising on more than US\$10 billion in assets under management (AUM) to include a report to their clients and society on how well they think their fund managers are integrating sustainability, or to explain why they have not done so;
- Develop integrated asset management: Governments to require on a comply or explain basis all fund managers with more than US\$10 billion under management to publish an integrated report for their asset owning clients and society by 2030, including details of how they have integrated sustainable development into all Annual General Meeting (AGM) voting, or to explain why they have not done so;
- Ensure integrated corporate brokerage: Governments to require all investment banks to have considered corporate performance on sustainability into all their recommendations to investors and advice to companies, or to explain why they have not done so;

‘ ...the primary failure of the capital markets in relation to sustainable development is one of misallocation of capital.’

“Good Governance and Capable Institutions”

- Improve integrated corporate governance: Governments to ensure all national corporate governance codes promote integrated corporate governance – i.e. corporate governance that integrates sustainable development;
- Improve integrated reporting by companies, investment banks, stock exchanges, asset managers, investment consultants, asset owners and proxy voting agencies: Governments to establish a national legislative framework requiring participants in the capital market supply chain to produce an integrated sustainability report to society – on a mandatory comply or explain basis;⁷
- Improve integrated proxy voting: Governments to call for proxy advisers⁸ to integrate corporate sustainability performance into their advice to asset managers and asset owners on director (re)election, directors’ remuneration, and the quality of corporate integrated reports, or to explain why they have not done so;
- Establish integrated investment legal duties: for long-term sustainable development to be incorporated into the legal duties of market participants including, in particular, their fiduciary duty and duty of care of asset managers and investment consultants;

The above systemic interventions will work in concert, reinforcing each other and ensuring continuity throughout the capital supply chain.

Financing the future we want

Global capital markets should be among the primary facilitators of a sustainable global economy. Indeed, the creativity, entrepreneurship and innovation funded by capital markets should be the driving force behind a globally green and just economy. Fortunately, sustainable development issues do not arise from a lack of financial capital, as the markets have the financial firepower to deal with them now. They arise from the mispricing of sustainability issues and the ensuing misallocation of capital.

We need policy makers to work on the price signals and internalise corporate externalities onto company accounts via, for example, increased use of fiscal measures, standards and market mechanisms. We believe that it is well within the collective ability of our governments to ensure that capital markets enhance corporate sustainability and promote long-term business behaviour. They will need to deliver integrated reporting and require responsible investment. This will help resolve the underlying problems associated with unsustainable development that have been set out within the SDG process. It will also promote financial stability and long term economic growth.

Notes

1. This article is an extract from an Aviva White Paper: “A Roadmap for Sustainable Capital Markets: how can the UN Sustainable Development Goals harness the global capital markets?”, available at www.aviva.com/roadmap
2. Brundtland, G.H., *Our Common Future*, World Commission on Environment and Development, 1987.
3. <http://sustainabledevelopment.un.org/owg.html>
4. Following a round table discussion with a group of sustainable finance experts, this proposal and the one related to footnote 7, were regarded to be the two key next steps for policy makers that are seeking to integrate sustainability into sustainable capital markets.
5. <https://www.cfainstitute.org>
6. Such as pensions, insurance companies, foundations and sovereign wealth funds.
7. Following a round table discussion with a group of sustainable finance experts, this proposal and the one above, were regarded to be the two key next steps for policy makers that are seeking to integrate sustainability into sustainable capital markets.
8. Proxy advisors produce recommendations for fund managers in relation to how to vote their shares at company AGMs.



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Should Sovereign Wealth Funds finance domestic investment? The opportunities and the risks

Sovereign Wealth Funds (SWFs) now own over US\$6 trillion in assets, about half of which belongs to resource-exporting countries. Responding to the funds' objectives to sterilise large export windfalls, saving for future generations, and balance risks and returns, their holdings have traditionally focused on external assets, primarily securities traded in major markets but also property and other investments. Some SWFs with long-term investment horizons have invested in infrastructure projects, but these have mainly been in other countries - high-return existing infrastructure and low-risk new bankable projects in Europe and Asia. The motivation for these investments has been overwhelmingly commercial.

Some funds do invest domestically. In one study, domestic holdings constituted 16% of investments for a sample of 60 funds, although these included some pension funds.¹ Comparing existing SWFs, we found at least 13 with mandates to invest domestically. Until recently domestic greenfield infrastructure investment has remained largely uncharted territory. But in the light of pressing infrastructure needs, several resource-rich developing countries have established, or are establishing, SWFs with an expanded role as a national investor, including in "strategic" projects. Angola, Nigeria, Papua New Guinea and Mongolia are among the most recent examples. More are in the making, including Colombia, Morocco, Tanzania, Uganda, Mozambique and Sierra Leone. Many of these recent and planned funds are in resource-rich countries.

“Sovereign Wealth Funds now own over US\$6 trillion in assets, about half of which belongs to resource-exporting countries.”

Some governments may see the SWF as a means to improve the quality of public spending, and to crowd in private investors to strengthen investment discipline.

Why the trend towards domestic investments?

Several factors are encouraging governments to turn to their SWFs to finance new infrastructure. Needs in these countries remain high, so that popular sentiment pushes governments to spend part of their accumulated financial wealth at home. Some have also seen constraints on access to traditional sources of infrastructure financing since the global financial crisis. Also, public investment in resource-rich countries often poses significant management and governance challenges, including low capacity, weak governance and regulation and lack of coordination among public entities. Some governments may see the SWF as a means to improve the quality of public spending, and to crowd in private investors to strengthen investment discipline.

Relaxing fiscal rules?

The trend has also been encouraged by new thinking on fiscal rules. For many years experts and International Financial Institutions (IFIs) have urged resource exporters to base public spending on some version of a permanent income approach. Broadly speaking, the non-resource fiscal deficit (total spending less non-resource tax revenue) should equal the sustainable income from resource wealth, $r \times W$, where 'r' is the long-term return on investments and 'W' is total resource wealth. This places a cap on public spending, especially when resource markets are booming or the country has only a few years of reserves. More recent thinking, initially in the context of Ghana, relaxes this constraint in cases where public spending includes domestic investments with high economic and social returns. These domestic investments, it is argued, contribute to national wealth and perhaps also offer higher returns than investments abroad, especially in poor African countries.² This opens up scope for the SWF to invest at home as part of its wealth management strategy.

A risky proposition

All options for managing resource rents have advantages and risks. The traditional approach helps to stabilise spending in the face of uncertain resource rents and to maintain budget discipline. This increases the likelihood that spending will be scrutinised for quality. On the other hand, some high-return domestic investments might not be funded as quickly as they could be. Also, a large SWF is vulnerable to being raided by future, less prudent, governments. If the fund has, or engages, the necessary expertise it could also act as a specialised investor, helping to crowd in private investors through well-designed public-private partnerships.

On the other hand, opening the door to domestic investment introduces very serious risks. The owner of the SWF – the government, on behalf of the nation – is also the promoter of the investments. The quality of the fund's portfolio can then be undermined by politically driven decisions, with "investments" contributing neither to growth nor to increasing the wealth of the nation. The SWF could be used to bypass parliamentary scrutiny of spending, resulting in even more inefficient and fragmented public investment programs. SWFs are particularly vulnerable to these risks because, unlike pension funds or development banks, they have no creditors able to exert due diligence in an independent manner. Governments could reclassify much recurrent spending as investments, which in some sense many are – education, health, early childhood development to name just a few. Bypassing the budget means that there is then no effective fiscal rule to constrain spending, increasing the possibility of destructive boom-bust economic cycles.

How to mitigate the risks?

The basic conflict-of-interest posed by state ownership cannot be eliminated but it can be mitigated by good policies.

Coordinate strategic investments

If operating as a purely market-driven investor the SWF might be seen as no different to any private investor. But this changes with domestic investments, especially those of a "strategic" nature, that need to be considered in the context of the public investment program and the implementation of macroeconomic policy. Massive fund investments in times of high resource prices could otherwise destabilise the economy even if budgetary spending is contained.

Finance the right investments for a wealth fund

Public investments can be evaluated from two perspectives: their private or financial returns and their broader economic or social returns. An infrastructure project may provide economic externalities, such as the stimulation of private investments and jobs, that are not fully captured by its financial return. While social and economic returns should be high, wealth fund investments must also yield "acceptable" financial returns. Some development finance institutions offer examples, such as rates of return that exceed inflation (Financiera Rural of Mexico and Credit Bank of Turkey), or that at least equal the government's long-term borrowing costs (Business Development Bank of Canada) or provide an explicit target return on capital, ranging from 7 to 11% annually (Development Bank of Samoa, EXIM Bank of India, Kommunalbanken of Norway).

Investments should be competitive

Allocations to domestic investment should not be in the form of a mandated share but determined on the basis of competition with the returns on foreign assets. When domestic returns are low or there are indications of asset bubbles, investment should be channeled abroad. This will need to take into account the policy on benchmark rates of return as discussed previously.

Pool investments

Investing with private investors, pooling with other SWFs and co-financing with the regional development banks could help the SWF to reduce risk, bring in additional expertise and enhance the credibility of the investment decision. Some SWFs, such as Nigeria's, have signed cooperation agreements with major international investors. Limiting investments to minority shares would serve to reduce risks of politically motivated allocations.

Strong corporate governance

There is a large body of knowledge on effective external governance (between the State and the SWF) and internal governance (the composition and functioning of the board of directors or trustees and the management processes of the SWF), including the Santiago Principles, the Revised Guidelines for Foreign Exchange Reserves, as well as general principles of governance practices including for state owned enterprises, put out by the OECD. The following aspects are most relevant for SWFs mandated to invest domestically:

- **Independent board.** This can be facilitated by independent nominating committees as well as clear skill requirements. Ownership and supervisory roles should be clearly separated.
- **Professional staffing.** To operate as an expert investor, the SWF needs to be staffed with qualified professionals, just like any investor in the financial sector. Strategic and greenfield investments require special expertise.

- **Transparent reporting, especially on strategic investments.** Consistent with good practice, SWFs investing domestically should issue accessible public reports covering activities, assets and returns. Where part of the portfolio is invested in “strategic” projects or projects with returns expected to be below market, these should be reported on separately.
- **Independent audit.** Internal audit should report directly to the board and external audit be undertaken by an internationally reputable firm that is independent of the owner.

Concluding remarks

The emergence of SWFs as strategic domestic investors, including in infrastructure, has important implications for the use of resource rents in the years ahead. Hopefully they can inject a degree of discipline into the use of these resources, and help their countries avoid the “resource curse”. However, they also have the potential to exacerbate the mismanagement of resources that has plagued so many oil and mineral-exporting countries. It remains to be seen how the political economy of this story plays out in the future.

Source: Sovereign Wealth Funds and Long-Term Development Finance: Risks and Opportunities. 2014. Policy Paper 041, Center for Global Development. May. The views expressed in this paper are those of the authors and not necessarily those of the World Bank.

Notes

1. Truman, E. M. 2011. Sovereign Wealth Funds: Is Asia Different? Working Paper 11-12, Peterson Institute, Washington, DC.
2. For more discussion, see Baunsgaard et. al. 2012. Fiscal Frameworks for Resource-Rich Developing Countries. IMF Staff Discussion Note, SDN/12/04 May.



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Illicit financial flows from Africa: signs of a poor integration into the global economy



Whether one looks at the figures in absolute or relative terms, the outflow of illicit financial flows (IFFs) from Africa is staggering. Ever since the landmark study by the African Development Bank¹ and Global Financial Integrity² described Africa as a net creditor to the world of some US\$1.4 trillion between 1980-2009, studies have proliferated on the subject. The significance of these figures is that they demonstrate the extent to which international trade, indeed, integration into the global economy, is not proving to be a viable development option for the continent.

Illicit financial flows are monies illegally transferred off-shore (even if they result from legal transactions) in contravention of the laws of the country of origin. They range from simple private individual transfer of funds to private accounts abroad, to highly complex schemes involving sometimes criminal networks that set up multi-layered, multi-jurisdictional structures to hide ownership. Whilst criminal activities are often the most cited, it must be borne in mind that a staggering 52% of IFFs results

from cross-border tax evasion. For instance, a study by AFRODAD³ on IFFs in Zimbabwe showed that the country lost US\$239 million in export under-invoicing, 44% of which resulted from its trade with Japan.

Re-assessing trade relations

At the dawn of the new era of a Global Partnership for Effective Development Cooperation (GPEDC),⁴ the question is being asked as to

how, under these circumstances, Africa can finance its development aspirations without a comprehensive re-assessment of its relations with the rest of the world. Central to the post-2015 agenda, is a reduction in inequalities within and between nations. The Intergovernmental Committee of Experts on Sustainable Development Financing (IGCESDF), in its final draft of the 8th of August 2014,⁵ concedes “the stock of global financial assets – a placement for only a small portion of annual global

savings - is estimated to be around US\$218 trillion. Even a small shift in the way resources are allocated would have an enormous impact”.

The challenge for the global community, under the new GPEDC and the post-2015 Agenda is to make this shift happen. Paragraph 40 of the IGCEsDF is even more explicit: “In many countries, tax evasion and avoidance hinder domestic resource mobilization. In addition, illicit financial outflows, including tax evasion across borders, have undermined tax collection. Estimates of illicit financial flows, by nature clandestine, vary widely, but point to substantial numbers”.

This then is the extent of the challenge that IFFs present to Africa: loss of opportunities for development investments and a clear sign of a “not-so-beneficial” integration into the world economy. African governments, in general, are indeed concerned about the losses through IFFs, witness the AU’s commissioning of a report on the subject. However, action by even the African Union as a body (not to mention at individual country levels), will fail to make any breakthroughs in resource mobilisation for a number of reasons.

Obstacles to resource mobilisation

The first reason is that national level legislations are inadequate to arrest predatory behaviour of companies that have long ago created supra-national networks. The practice of base erosion and profit shifting (BEPS) by highly integrated multinational corporations (MNCs) makes it extremely difficult, if not impossible, for any single government (or governments for that matter) to address unfair transfer pricing and internalised transactions of MNCs operating as global networks. Yet the integration of African economies into global trade and investment markets is massively through these

MNCs, following years of structural adjustments and divestiture programs launched by the International Monetary Fund and the World Bank. Across the continent, there has been a significant shift in economic power from central and local governments to impersonal trusts and anonymous company owners.

A second reason lies in competition among African countries for foreign direct investment (FDI) flows to the continent. The practice of enticing investors with fiscal and financial incentives makes it difficult for any government to drive hard bargains with prospective investors. Recently, the systematic use of double-taxation agreements as part of the packages discussed with investors has raised alarm about fiscal benefits of foreign investments. The weak bargaining power of respective governments is exacerbated by information asymmetry with regards to resource reserves, international market prices and internal cost structures of licence holders.

Global economy integration an illusion?

A seminal study titled “The Revenue Costs and Benefits of FDI in the Extractive Industry in Malawi; The case of the Kayelekera Uranium Mine”⁶ uncovered that weak legislation and institutions fail to hold MNCs accountable for their tax obligations and remittances to government. “Taxation laws fail to adequately address issues of capital flight, tax avoidance or evasion, which the study findings have revealed are being perpetrated by MNCs”.

With limited strategic options to improve returns from its trade with the rest of the world, the continent is only left with global platforms at which it can make a case for fairer returns from commercialisation of its resources. These platforms have been, at best, disappointing. From the WTO Trade Conference in Bali

to the OECD exclusion of developing countries from BEPS discussions, the call by some European countries to block the proposal to establish a UN Tax Committee and a Debt Workout Mechanism to the discussions on Financing for Development, the likelihood of a global concerted effort to redress Africa’s poor integration into the world economy and to improve its share of trade proceeds remains an illusion. Illicit financial flows are only one of the symptoms of the non-benefitting trade relationship with the rest of the world.

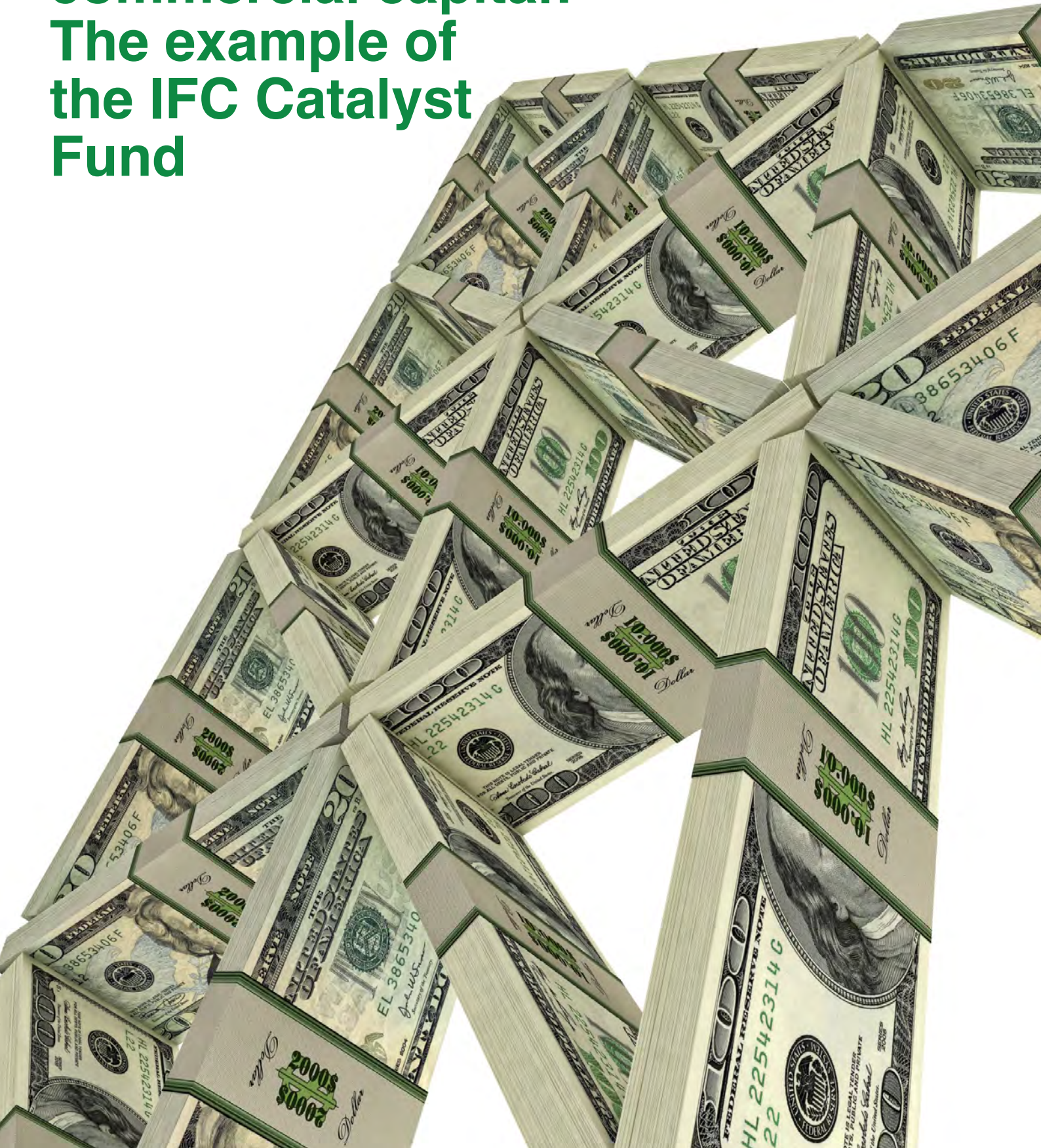
Notes

1. See for instance www.afdb.org/en/annual-meetings-2013/programme/africa%E2%80%99s-illicit-financial-flows-what-do-they-tell-us/
2. www.gfintegrity.org/issue/illicit-financial-flows/
3. “An Assessment of the Extent, Main Drivers, Processes and Impacts of Illicit Financial flows in Zimbabwe”, AFRODAD August 2014.
4. <http://effectivecooperation.org>
5. <http://sustainabledevelopment.un.org/content/documents/4588FINAL%20REPORT%20ICESDF.pdf>
6. AFRODAD. 2013. The Revenue Costs and Benefits of FDI in the Extractive Industry in Malawi The case of the Kayelekera Uranium Mine.



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Public funds to mobilise commercial capital: The example of the IFC Catalyst Fund



Addressing climate change is a critical global challenge. The costs associated with mitigating climate change are immense; the International Energy Agency estimates investment of US\$5 trillion is required by 2020 in clean energy alone to limit global warming to 2°C¹ with additional investment required for adaptation to the effects of climate change. Governments have a key role to play in helping to finance and support climate change mitigation and adaptation, but with limited resources and multiple priorities, they need to think strategically about how to achieve results most effectively. Crucially, for there to be any prospect of realising the necessary investments, limited public funds need to be deployed in a manner that mobilises extensive commercial funding sources.

The IFC Catalyst Fund (“Catalyst” or the “Catalyst Fund”) is one example of such strategic, innovative financing, whereby a fund focused on commercially attractive investments in the climate/resource efficiency space in emerging markets has been sponsored by International Finance Corporation (“IFC”) ², co-anchored by public sector investors³, and has also raised additional funds from commercial investors.

In addition to its relevance for the climate space, lessons from the Catalyst experience may also be relevant in considering how public monies can be used to mobilise commercial funds for investment in other areas where achievement of public good outcomes at scale requires the participation of commercially-oriented investors, and where a sufficient portion of underlying investments offer a commercially attractive risk-return profile.

Design

In early 2010, the UK government approached IFC with the idea of developing a vehicle in which the UK could co-invest, with the understanding that IFC – in addition to investing itself – would raise third-party, commercially-oriented capital to invest in the climate space in emerging markets. In mid-2010, a small team from the IFC Asset Management Company (“AMC”) ⁴ began working on the project, which culminated in the establishment of the IFC Catalyst Fund. In designing this vehicle, it was crucial to balance two sets of complex, and sometimes competing, priorities: those of the private sector, and those of the public sector.

Private-sector and other commercially-oriented investors are primarily focused on risk and reward, including key considerations such as:

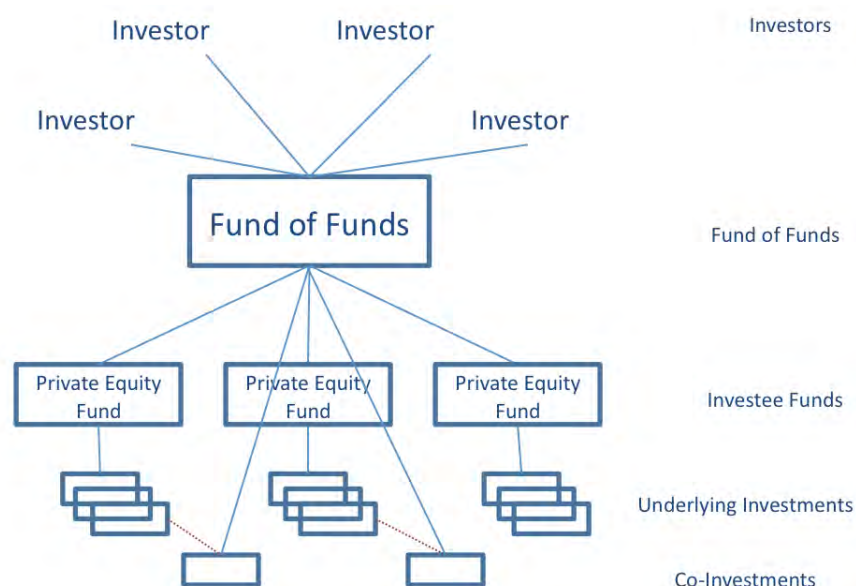
- Investing in a space that has the potential for deployment of substantial capital while offering attractive risk-adjusted returns and helping to diversify their existing portfolio of investments;
- Working with an intermediary (such as a fund manager) that is credible and that has a strong, relevant track record;
- Co-investing with partners who share a similar philosophy and focus on commercial returns;

- Investing through a market-accepted structure with reasonable costs;
- Investing on terms that are consistent with market norms.

For the public sector the equation includes a number of complex issues, such as:

- How to balance competing objectives, such as deploying capital in poorer emerging markets vs. addressing climate change on a large scale, which typically involves investing in middle-income countries (which are larger emitters);
- Whether there is an acceptable role for public financing in investing *pari passu* with commercial investors in a for-profit venture? What is the market failure that public financing is seeking to address in such a for-profit venture? Or is the hallmark of public financing an element of subsidy designed to overcome the market failure?
- Whether this is the best use of scarce public funds? What is an adequate mobilisation ratio?
- Whether – if the funding source is from an Official Development Assistance (“ODA”) budget – the venture can be designed to comply with ODA-eligibility rules, including handling reflows?

Diagram 1: Structure of a Fund-of-Funds



- The importance of working with a credible and reliable intermediary (such as a fund manager) who can be entrusted with public funds.

Over several months, the AMC team, drawing on IFC's market knowledge and experience together with support from external advisors, worked through these and other issues with public-sector counterparts including the UK government, as well as with counterparts from potentially interested commercial investors. A number of Catalyst's key design features were determined through this process:

- It became clear that, to be attractive to private sector investors, a suitable vehicle would need to be structured on a fully commercial basis, with financial returns as its core objective; this also meant that there could only be the broadest of geographic restrictions;
- Both public and private sector investors required a trustworthy, experienced manager, and that the governance of the fund be independent of political influence;
- We decided that the vehicle itself would not be the beneficiary of any subsidy⁵, although it could invest in underlying projects where a subsidy element from other sources might be part of the equation (e.g. incentives to encourage renewable energy);
- Our market analysis showed that potential investments in the climate/resource efficiency space are generally small, early-stage⁶, and illiquid, have a high risk-reward profile, and that they require the application of specialised skills and expertise as well as capital. In view of this, we decided that the private equity fund⁷ model was most suitable.

Furthermore, we decided to structure the vehicle as a fund-of-private-equity-funds (see diagram above), i.e. a vehicle that invests primarily in private equity funds. Fund-of-funds are well-established in the marketplace and have the benefit of being inherently highly diversified; furthermore, by working through private equity funds, we would ensure that the managers of the investee funds would have the financial and operational resources to assist their investee companies as required to create value.

The decision to use a fund-of-funds model was the result of extensive market testing, during which several alternative structures were considered. We felt that it was crucial to avoid preconceived notions as to appropriate structuring, and to let market feedback guide our decision-making. Ultimately, we determined that the fund-of-funds structure aligned well with the goals of both the commercial investors and the public sector investors.

Of interest to both sets of investors, a fund-of-funds is inherently highly diversified, resulting in a lower likelihood of capital loss. The structure allows commercial investors to efficiently deploy sizeable amounts of capital through one vehicle, and helps them gain exposure to, and learn about, unfamiliar sectors and geographies by delegating investment responsibility to a knowledgeable fund-of-funds manager. Of importance to public sector investors, a fund-of-funds provides substantial mobilisation effects. A fund-of-funds typically invests in about 15 investee funds, which in turn invest in 10-12 portfolio companies each (with additional equity raised at each level, and additional debt

raised at the portfolio company level).⁸ This translates into capital mobilisation and development impacts (which for climate funds include avoided carbon, job creation, clean power generation, etc.) that are significantly amplified relative to the original public sector investment.

IFC Catalyst Fund overview

In December 2012, the IFC Catalyst Fund⁹ held its first closing, raising approximately US\$280 million from four investors (including the UK and IFC).¹⁰ The Catalyst Fund will, over time, invest in about 15 specialist climate-focused private equity funds, broadly diversified by sector, stage, geography and vintage. It invests across global emerging markets in growth equity and early-stage asset development projects. Its sectoral remit is consistent with IFC's definition of climate investments, focusing on high-growth companies and projects in renewable energy, energy efficiency, water efficiency, agriculture, adaptation, and environmental services, as well as their supply chains.

Table 1: IFC Catalyst Fund Investors

Investor Type	Number	Commitment (US\$m)
Government	3	172.8
Pension fund	2	70.0
Sovereign wealth fund	1	50.0
Public finance institution	1	50
Parent organization (IFC)	1	75.0
Total	8	417.8

AMC manages the Catalyst Fund, implementing an established business model whereby Catalyst has the right to participate in IFC investments, benefitting from IFC's resources and experience in identifying, evaluating, transacting and monitoring investments, while maintaining independence in investment decision-making.¹¹ In particular, IFC has a strong track record of fund investing, achieving top-quartile returns compared to relevant benchmarks, over a sustained period of time. This combination of IFC's track record, its on-the-ground knowledge of governmental, regulatory and legal systems in emerging markets and AMC's independent, fully commercial decision-making, represented a choice of manager that appealed to both public and private sector investors.

In June 2014, Catalyst held its final close at US\$417.8 million, see Table 1, from eight investors – to date, the largest emerging markets climate-focused fund-of-funds listed in the Preqin database of funds and fund managers. As anticipated, meaningful initial commitments from public sector investors enabled successful fundraising from commercial sources, with two pension funds and one sovereign wealth fund joining the investor group. These investors invested on purely commercial grounds, attracted by: the opportunity in the climate/resource space in emerging markets; the strength of support from the public sector in seeding Catalyst; the diversification, risk mitigation, and access of the fund-of-funds structure; as well as by the strength of the partnership with IFC and the independence of the AMC platform.

Table 2: IFC Catalyst Fund Commitments

Fund	Geographic Focus	Sectors	Vintage (First Close)	Catalyst Commitment
Armstrong South East Asia Clean Energy Fund	South East Asia	Renewable energy	2013	25.0
China Environment Fund IV	China	Cleantech/resource efficiency	2011	15.0
Latin Renewables Infrastructure Fund	Latin America	Renewable energy	2012	19.9
TPG Alternative and Renewable Technology Partners	Global	Industrial biotech/energy efficiency	2013	35.0
Asia Environmental Partners II	Pan-Asia	Renewable energy/resource efficiency	2014	35.0
Total				129.9

Investment program

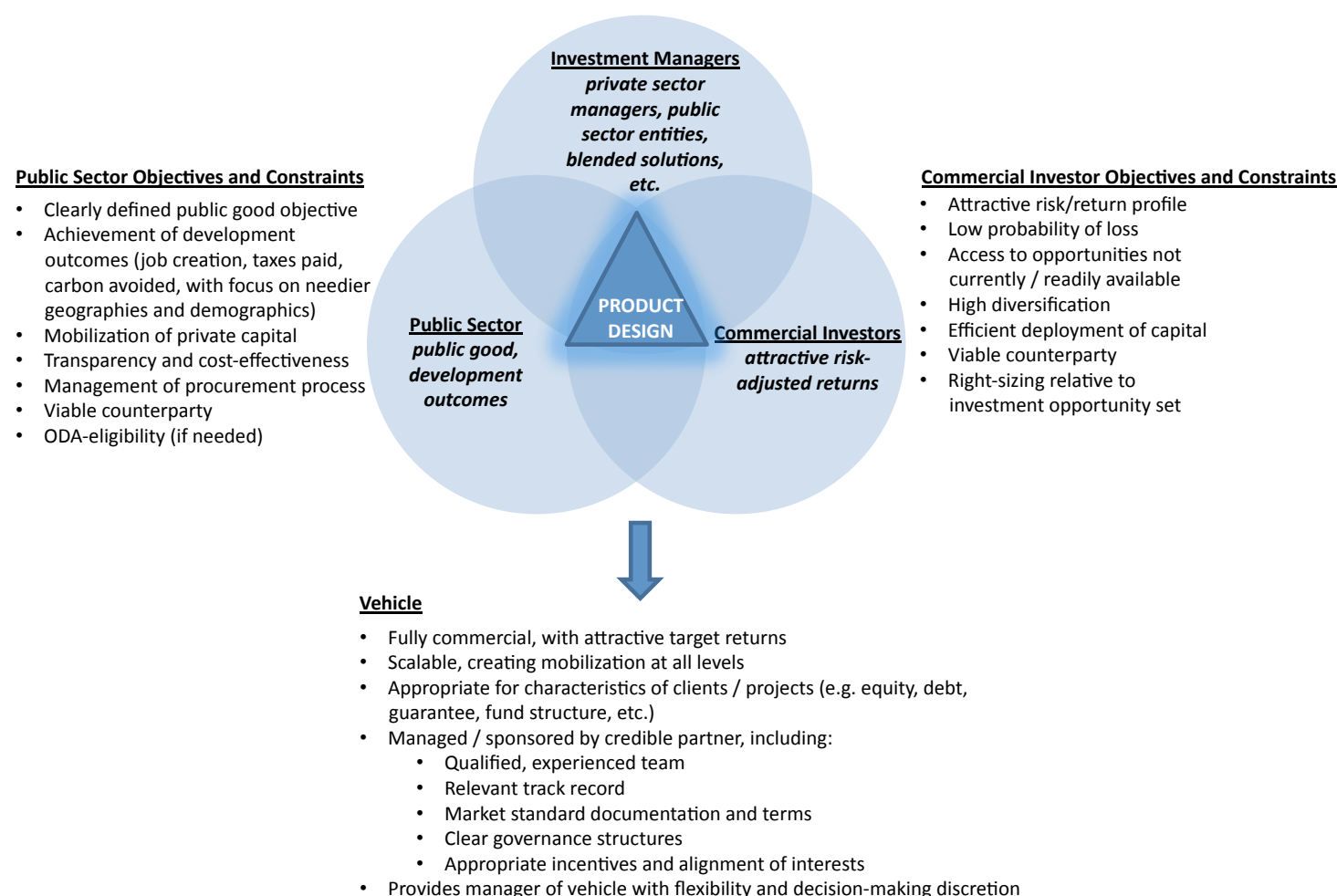
The Catalyst Fund has been operational for 18 months, and has made significant progress in executing on its investment strategy and program, having to date committed an aggregate US\$130 million to five climate-focused private equity funds (see Table 2 below). Catalyst's portfolio already shows diversification across strategies, geographies, sub-sectors, and vintages. These five investee funds (which have, in aggregate, raised additional capital of US\$756 million, or 5.8x Catalyst's commitments) have, to date, invested in 20+ portfolio companies across a highly diverse range of industries, including transactions in solar PV generation, small hydro power generation, PET bottle recycling, LED lighting, PV optimiser systems, and green chemicals.

Generalising the model

The Catalyst Fund has demonstrated that public capital invested through a suitably structured private equity fund sponsored and managed by credible counterparts, can mobilise commercial money in order to invest on a for-profit basis while also addressing a critical public good. Furthermore, the ultimate commercial success of Catalyst (which has yet to be proven since it is early in its investment cycle) would result in a "demonstration effect" and help to stimulate the development of new vehicles addressing the climate/resource efficiency space in emerging markets.

More broadly, we would hope that the essence of the Catalyst model can be applied in other verticals – potentially including infrastructure, healthcare, education, and others – where commercially attractive investments, made through a suitably structured and managed vehicle seeded by the public sector, can generate public

Diagram 2: A Model for Product Design



“ We felt that it was crucial to avoid preconceived notions as to appropriate structuring and to let market feedback guide our decision-making.”

goods prioritised by the public sector. While the core characteristics of blended public and private finance delivered through a suitable commercial for-profit vehicle would be common to these various verticals, the details, including type of financial product, and specific outcomes to be achieved – will differ from vertical to vertical. In evaluating whether a Catalyst-type model can work in other sectors, key considerations include: what are the characteristics that make this an appropriate sector for blending public and private capital? Is there sufficient potential interest from commercial investors? Are there sufficient targets for investment? Who are the suitable managers? How should the vehicle be structured to achieve its objectives? How much public finance support is required?

A one-size-fits-all solution will not work, but elements of the Catalyst model – in particular using public money to mobilise commercial for-profit investment which also generates public goods – may be relevant, and can be tailored to the needs and opportunities of a given vertical, extending the approach and helping the public sector achieve more with less.

Notes

1. International Energy Agency. http://www.iea.org/publications/tcep_web.pdf.
2. IFC is a member of the World Bank Group and is the largest global development institution focused exclusively on the private sector.
3. The governments of Canada, Norway, and the United Kingdom, as well as the Japan Bank for International Cooperation and other institutional investors, have invested in the IFC Catalyst Fund.
4. AMC is IFC's fund management business, managing third-party capital across six funds that invest in IFC transactions in developing countries. AMC, a wholly-owned subsidiary of IFC, was established in 2009; as of June 2014, AMC had approximately US\$6.3 billion of assets under management and had committed approximately US\$3.8 billion in 53 emerging market companies and 4 private equity funds. A commitment to 1 additional private equity fund was made in August 2014.
5. We considered the potential benefits of including a subsidy in the vehicle's waterfall, but recognised that, as private sector investors are not accustomed to that type of structure, the private sector leverage impact was likely to be greater without a subsidy. The decision was thus made that all investors (public and commercially-oriented) would invest *pari passu*.
6. In the sense that they may involve the adoption of a new business

model or the deployment in new markets of technologies developed elsewhere; in a few cases, such projects may also involve the development/exploitation of new technologies.

7. Private equity funds inject capital into the riskiest part of the capital structure. These funds typically also support investee companies with expertise across a range of areas, including governance, recruitment, operations, sales and marketing, and business development. This is well summarised in "Public Private Equity Partnerships: Accelerating the Growth of Climate Related Private Equity Investment." Report summary available at: http://www.ifc.org/wps/wcm/connect/2383a7004a95d078ac0aeceec99f439e/IFC_Brief_PPP.pdf?MOD=AJPERES.
8. If one assumes that the fund-of-funds takes a 20% interest in a typical investee fund (with the balance of 80% raised from other investors), and that the investee fund provides 25% of a portfolio company's equity (mobilising 4x the fund's investment from other investors), the equity multiplier on the fund-of-fund's investment is 20x. This does not include debt raised by the portfolio companies, which would further increase the multiplier.
9. More information at: <http://www.ifcamc.org/funds/ifc-catalyst-fund/>.
10. Press release at: <http://ifcext.ifc.org/IFCExt/pressroom/IFCPressRoom.nsf/0/7C6F129C88D9CAED85257992003055EB>
11. A decision to invest by Catalyst can only be made by its Investment Committee, which makes decisions independently from IFC. All Catalyst investments follow IFC's policies with regard to environmental and social standards, integrity due diligence, and other matters.



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Johanna Klein is Senior Investment Manager of IFC Catalyst Fund.



Development finance – Upside down

Though Africa is still often portrayed as a continent full of misery, Africa now contains 7 or 8 (depending on the source) of the world's 10 fastest growing countries—a figure which we often forget. Another stunning statistic also comes from the continent: over 40% of Kenya's GDP passes through MPesa, Kenya's popular mobile payment platform. Indeed, over half of all mobile payments *globally* take place in Kenya. These are only a few of the statistics illustrating the rapidly changing environment for development today.



“...recent statistics tell a compelling story of a mega-shift from largely public sector funding to a situation where the private sector acts as the main engine for growth and change.”

Changing mentalities in development finance

I often ask various decision-makers in the development community on their views on the most important factors in helping hundreds of millions of people escape poverty during the last decade. What sources generated sufficient funding for making such investments feasible? The typical responses rarely, if ever, bring the private sector to the forefront.

Yet recent statistics tell a compelling story of a mega-shift from largely public sector funding to a situation where the private sector acts as the main engine for growth and change. Whereas a decade ago, the amount of funding from public and private sector sources was still about the same, the latter now outpaces the former many times over in developing markets. Private-sector funds not only finance private enterprises, but are increasingly playing a role in providing long-term capital to governments in Africa and other developing markets, as well as supplementing traditional donors by helping meet needs for grant-based funding. Developing countries have become “emerging economies,” or “frontier markets”. Acronyms like BRICs or “the next 15” have become commonplace. More broadly, private sector-driven growth has helped hundreds of millions of people worldwide to escape poverty during the last decade alone.

The development community needs to embrace this mega-shift, which has *already* taken place. People working on development issues in relevant ministries need to stop living in the development architecture of yesterday and adopt that of present – or even that of the future. We need to recognise the fact that traditional donors, that is, Western, mostly European countries, will be battling high public debt levels for years to come. Hence, even if they wanted to, they would not have resources to directly match current funding needs through grants alone. Rather, the scarce money that is available must be used to achieve the optimal development impact, rather than simply ‘more of the same.’ This also means ending allocation of scarce development money simply on the basis of historical needs or historical donor architecture.

Yet, both the general public and the broad development community are still stuck with a largely outdated image of developing countries as inhospitable places where famine and various other disasters, natural and man-made, prevail. Though these continue to be important themes in certain fragile or war-torn countries, such humanitarian emergencies are not nearly as frequent as they were a few decades ago.

Rather than focus on famines, the development community should embrace the fact that emerging markets are increasingly becoming co-drivers in a global community, and in fostering economic growth.

New models for development finance

The private sector, to be sure, is not the answer to all development challenges. But, it is an important part of the solution and, when combined with appropriate public interventions, can significantly accelerate positive development results.

The public sector's primary role in policy-making remains key to success. It is crucial to create a policy framework that encourages and facilitates productive private sector investments. The much-debated 'Doing Business Report' by the World Bank¹ has triggered welcome competition among governments on improving their rankings. While not perfect, the focus it has generated more than offsets its potential deficiencies. Indeed, the important role of public sector in setting the 'right' regulations is becoming ever better understood.

The public and private sectors are working together much more than before, and in more creative ways. Public Private Partnerships (PPPs), for example, have become well established in projects where the private sector can only take part of the risk, and needs public sector funding or guarantees to make a project or investment financially feasible, or in countries that have reached their debt ceiling and need to find innovative methods to provide public services. PPPs are, furthermore, becoming a dominant model in infrastructure investments, where annual funding needs run to hundreds of billions of dollars annually just to maintain the current level of infrastructure.

Blended funding, meanwhile, mixes pure commercial money with grants or first loss guarantees to encourage the private sector to venture into an industry segment or geographical area where return expectations are not otherwise commensurate with risks. Examples of success in blended funding can be found in health care, education, smallholder farming, renewable energy and micro enterprises.

Though blending public and private money has been, and continues to be, controversial, bringing the private sector in has brought numerous benefits. Not only does the private sector have deeper pockets, and is hence able to provide more funding; rather, private-sector efficiency has also led to a drive to measure the impact of development funding and of individual projects much more accurately than before, resulting in the birth of a whole new industry. The official amount of development assistance alone is not, and should not, be used as the key criteria; rather, focus has shifted to the actual impact on beneficiaries per dollar spent.

Private sector's emerging role in community development

Though the private sector has historically faced criticism for not doing enough to address externalities, much has changed in recent years in this area as well. For example, if you compare a mining investment a decade ago with one from today, the difference is striking: there has been a huge shift in how to deal with environmental issues, as well as the impact on the local community. Extractive industries have adopted voluntary standards and guidelines on tackling difficult issues, which has not only improved community relations but has also lowered risk, and hence increased adjusted long-term returns for investors.

Similar voluntary norms dealing with environment, local communities, and social issues have been adopted by banks on project finance. Private-sector funding with appropriate safeguards has helped all industries recognise the benefits of sustainable finance.

Embracing the changes

The development community needs to embrace change, rather than remain fixated with the ineffective use of ODA money. Poverty on a massive scale in developing countries is projected to nearly disappear within the next 50 years. This current positive trend, pushed by private sector-driven growth, can be accelerated and be made more 'fair' and sustainable through new models of public private funding and partnership. We should not stand in the way of this promising trend but need to embrace the changes it brings, not least within the broader development and donor community itself.

Note

1. See <http://www.doingbusiness.org/>

“...over half of all mobile payments globally take place in Kenya.”



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As previously reported, the ECOWAS-EU EPA was initiated on 30th June 2014 and formally endorsed by the West African Heads of States on 10th July 2014¹ and the SADC and EU negotiators sealed a deal on 15th July 2014 by “initialing” a regional EPA, covering Botswana, Lesotho, Mozambique, Namibia, South Africa and Swaziland.² In addition, on 25th July 2014, Cameroon completed the ratification of its interim EPA³ which was concluded at the end of 2007 and signed on 15th January 2009, following the approval by its National Assembly on 9th July and Senate on 10th July 2014. On 17th July 2014, the government of Fiji notified the European Union (EU) of its decision to start applying the Pacific interim EPA they had concluded jointly with Papua New Guinea at the end of 2007 and signed on 11th December 2011.⁴ Negotiations are still ongoing with EAC, now at Ministerial level.

Legal framework

The EC Market Access Regulation, MAR 1528/2007 was introduced at the end of 2007 to provide duty-free quota-free (DFQF) access to the EU market for products from ACP countries that had just concluded an (interim) economic partnership agreement with the EU. It was meant to prevent trade disruption before the (provisional) application of the EPA regime. MAR 1528/2007 requires however that EPA countries take, “within a reasonable period of time”, the necessary steps to ratify and implement their EPA agreement. In May 2013, a new EU Regulation 527/2013 was adopted to remove from the scope of MAR 1528/2007 (i.e. to delete from Annex I of the MAR) those countries that had not taken the necessary steps towards ratifying or implementing their EPA by 1st October 2014. This has been commonly referred to as the 1st October 2014 ‘deadline’ and concerned Botswana, Cameroon, Cote d’Ivoire, Fiji, Ghana, Kenya, Namibia and Swaziland.

Following the ratification of the interim Central Africa EPA by Cameroon and the necessary steps taken by Fiji towards ratification of the interim Pacific EPA, which it will apply, the European Commission adopted two delegated acts, in accordance with Articles 2a and 2b of MAR 1528/2007, to reinstate these countries in the MAR, by amending its Annex I.⁵

Delegated acts are decisions adopted by the European Commission, in accordance with Article 290 of the Treaty on the Functioning of the EU, on the basis of

the power delegated to the Commission by the European Parliament and the Council, after appropriate and transparent consultations, in line with paragraph 4 of the Common Understanding on delegated acts. The decision comes into force unless the Council or the European Parliament rejects it within two months.

In the context of the EPAs, the European Commission was eager to be able to adopt delegated acts before August, so that taking into account this two-month period, the delegated regulation could come into force before 1st October 2014, so as to avoid any trade disruption for the countries concerned.

Countries excluded from MAR 1528/2007 following the amendment by the EU Regulation 527/2013 could also be reinstated in Annex I by concluding negotiations on a new EPA, according to Article 2(2) of the MAR. So, following the conclusion of the SADC-EU EPA, this is the case for Botswana, Namibia and Swaziland, and for the ECOWAS-EU EPA, Cote d’Ivoire and Ghana, the European Commission acting again by delegated act.⁶

Hence, by concluding a regional EPA, agreed in July, these countries can *de facto* preserve their DFQF market access to the EU after 1st October 2014. The remaining 12 least developed countries in West Africa and Lesotho in SADC will continue to export to the EU under the DFQF provided under the Everything-But-Arms regime of the EU generalized system of preferences (GSP). Nigeria will continue to export under the EU standard GSP, Cape Verde under the GSP-plus, and South Africa the Trade, Development and Cooperation Agreement (TDCA). The EPA regimes will apply as soon as the agreements are signed, provisionally applied and/or ratified by the parties.

The European Commission also provided for the possibility that some countries having concluded an interim EPA in 2007 would not have either taken steps towards ratification of their interim EPA or concluded a new regional EPA before the 1st October 2014 deadline. Following the removal in May 2013 of these countries from the MAR 1528/2007 as amended by the EU Regulation 527/2013, the European Commission designed a delegated act to reinstate these countries under the EU GSP regime from 1st October 2014.⁷

EAC uncertainty and Kenya trade disruption

In practice, the only country really affected is Kenya, which will cease to benefit from the DFQF access under MAR 1528/2007 as of 1st October 2014. As *GREAT Insights* goes to press, the EAC negotiators were confident an agreement would be found with the EU to allow for the successful conclusion of their EPA negotiations but no deal has yet been reached.

As it would take about two months for the European Commission to have a delegated act decision approved to reinstate Kenya under MAR 1528/2007 following the successful conclusion of the EAC-EU EPA negotiations, Kenya will fall under the standard EU GSP from 1st October 2014, following the adoption of the European Commission delegated act on GSP to include all interim EPA countries concerned (listed above) in Annex II of the EU GSP Regulation 978/2012, as last amended by EU Regulation 1421/2013.

Under the EU GSP, Kenyan exports, in particular horticulture and some vegetable products, now given DFQF access, will face new tariff barriers, mostly between 8% and 12%. Kenya currently exports some US\$530 million worth of cut flowers and over US\$300 million worth of vegetables annually.

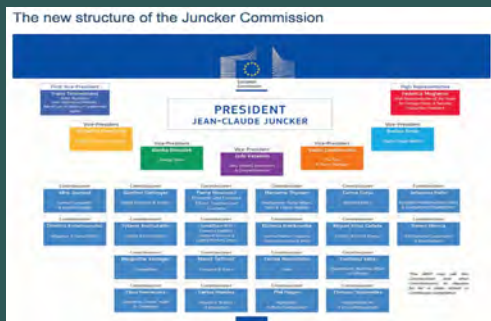
Notes

1. See <http://news.ecowas.int/presseshow.php?nb=134&lang=en&annee=2014> and <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1123&title=West-African-leaders-back-Economic-Partnership-Agreement-with-EU>. The text of the agreement is available at: <http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2013263%202014%20ADD%201>
2. See <http://www.dti.gov.za/editmedia.jsp?id=3079> and <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1135>
3. See http://europa.eu/rapid/press-release_IP-14-884_fr.htm
4. See <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1130&title=The-EU-and-Fiji-implement-the-Pacific-interim-Economic-Partnership-Agreement> and www.fbc.com.fj/fiji/21393/fiji-agrees-to-interim-epa-with-eu
5. C(2014) 5214 for Fiji and C(2014) 5274 for Cameroon, 25th July 2014. All acts are available at <http://register.consilium.europa.eu/content/int?lang=eng&type=smp1>
6. C(2014) 5210, 25.07.2014
7. C(2014) 5087, 22.07.2014

Talking Points

Current discussions on ECDPM's blog on the challenges of the EU's international cooperation
<http://ecdpm.org/talking-points>

The Top Jobs in Commissioners' Private Offices – Planning Fantasy Football with your Team



Talking Points, Andrew Sherriff, 12 September 2014

The Commissioner portfolios have now been allocated, but there are still a few jobs up for grabs in the private offices. These private offices known as Cabinets of the Commissioners for Trade – Cecilia Malmström, Development – Neven Mimica, Humanitarian Affairs – Christos Stylianides, Enlargement – Johannes Hahn and the High Representative/Vice President (HRVP) – Federica Mogherini, play a highly influential role in the EU's international effectiveness...

New European Commission structure should lead to more effective EU global action



Talking Points, Melissa Julian, 12 September 2014

On Wednesday, European Commission President-elect Jean-Claude Juncker put forward his proposals for European Commissioner portfolios and a new Commission structure. The new College will have seven Vice-Presidents, including the High Representative of the Union for Foreign Policy and Security Policy, each leading a project team. They will be steering and coordinating the work of a number of Commissioners. This aims to ensure a dynamic interaction of all Members of the College, breaking down silos and moving away from static structures...

How can The Netherlands most Effectively Contribute to Achieving Sustainable Food Systems?



Talking Points, Jeske van Seters, 2 September 2014

A review of Dutch food security policy is underway. By the end of this year, the Ministries of Foreign Affairs and Economic Affairs will send a joint food security policy paper to the Dutch Parliament. The Food & Business Knowledge Platform has launched an online consultation to ensure that the newest topics and debates on food security are included in the paper. The consultation is structured according to the five international targets of the Zero Hunger Challenge. Jeske van Seters adds her contribution to number 3 – ensuring 'all food systems are sustainable'...

Breaking Heads over Questions of Change



Talking Points, Frauke de Weijer, 27 August 2014

The approach is commendable, but we might ask whether the tools presented would be used by those elites that are in the position to use them effectively. In his article – and the book upon which it is based – Seth Kaplan aims to look at the power dynamics and the role of elites and then seeks ways to make the latter work more for the benefit of their countries and populations...

Monthly highlights from ECDPM's Weekly Compass Update

www.ecdpm.org/weeklycompass

Politically Smart Development | Four Messages on Governance and Water | The Future Africa Wants

Weekly Compass, 19 September 2014

The Overseas Development Institute (ODI) looks at seven cases where donors were successful at facilitating developmental change 'despite the odds' when they adopted politically smart, locally led approaches, adapting the way they worked in order to support iterative problem-solving and brokering of interests by politically astute local actors.

Who's got what it takes for EC top jobs? | Scottish Independence for Dev | Integrated Approach Essential to EU Global Role

Weekly Compass, 12 September 2014

On Wednesday, European Commission President-elect Jean-Claude Juncker put forward his proposals for European Commissioner portfolios and a new Commission structure. The proposals aim to ensure a dynamic interaction of all Members of the College, breaking down silos and moving away from static structures.

ETTG 'Our Collective Interest' | EU Evaluations Often Remain Underused | Extractive Sector: African Perspectives |

Weekly Compass, 5 September 2014

Following the European Council's agreement last Saturday to appoint Donald Tusk as European Council President and Federica Mogherini as EU High Representative for Foreign Affairs, the EU Council of Ministers is expected today to endorse the European Commission President-Elect, Jean-Claude Juncker's team of European Commissioners. Juncker intends to announce the distribution of portfolios mid-next week. The chairs of the European Parliament's committees plan to meet as soon as they know the identities of the next commissioners, to decide the schedule of their confirmation hearings with the Commission-designates to be held later this month.

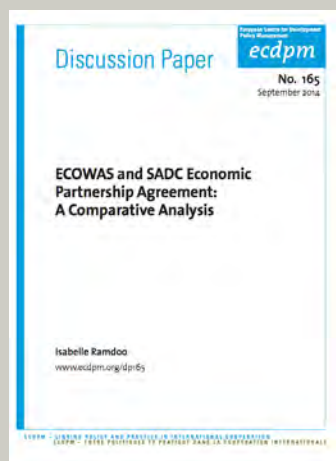
US-Africa Leaders Summit | Peace as a Global Challenge | Africa's Economic Transformation

Weekly Compass, 1 August 2014

The first US-Africa Leaders Summit will take place next week in Washington DC. ECDPM's Isabelle Ramdoo, in a new blog that is the Editor's Pick this week, explains it is a remarkable shift in the strategic and diplomatic repositioning of the US in Africa. Now, ECDPM's Andrew Sherriff and Volker Hauck ask more practically, will this be a great leap forward in actual practice? The new action plan for the comprehensive approach will help to gather momentum for more comprehensiveness and partnering across the Union, providing the basis for concrete joint action starting with early warning, joint analysis, political activities and programming. Yet ultimately the success of this endeavour will be judged on results, not communications and conclusions.

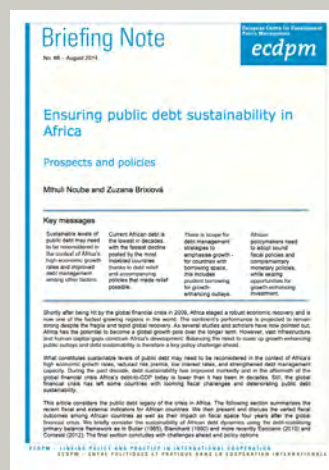
Latest ECDPM Publications

Ramdoo, I. 2014. ECOWAS and SADC Economic Partnership Agreement: A comparative Analysis. ECDPM Discussion Paper 165. Maastricht: ECDPM.



After 12 years of hard talks, the EPAs finally concluded with ECOWAS and SADC this year were made possible, largely due to the strong political leadership shown on all sides in order to ensure the smooth trade relationship with the EU and to maintain regional unity and solidarity.

Ncube, M., Brixiová, Z. 2014. Ensuring Public Debt Sustainability in Africa: Prospects and Policies. Briefing Note 66. Maastricht: ECDPM.



During the past decade, debt sustainability has improved markedly and in the aftermath of the global financial crisis Africa's debt-to-GDP today is lower than it has been in decades. Still, the global financial crisis has left some countries with looming fiscal challenges and deteriorating public debt sustainability.

Helly, D., Galeazzi, G., Pigné, J. 2014. Petit répertoire des expertises sur le Sahel : Diplomatie, sécurité et développement (Première version collaborative). Maastricht : ECDPM.



La région du Sahel connaît une mobilisation internationale historique : des milliards d'euros sont promis au Mali et à ses voisins, tandis que des dizaines d'agences internationales se pressent et déploient du personnel dont la connaissance du terrain demeure souvent limitée.

Ce répertoire est destiné à tous ceux qui cherchent à identifier des experts capables d'étudier et d'expliquer les dynamiques sociales, politiques et économiques ciblées par les nombreuses stratégies internationales pour le Sahel-Sahara.

Aggad-Clerx, F., El Fassi, S. 2014. Implementing African development initiatives: Opportunities and challenges to securing alternative financing for the Agenda 2063. ECDPM Briefing Note 65. Maastricht: ECDPM.



There is recognition within Africa that the continent needs to tap into its own wealth to finance its development agendas, most notably the African Union's Agenda 2063.

Significant efforts have been made to map the untapped alternative sources of financing from within Africa. These show that significant resources could be raised from within Africa, enough to cover about 70% of the development financing needs.

Next issue of *GREAT insights* on
“Economic Partnership Agreements and beyond” October 2014, Volume 3, Issue 9

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