



## POLICY BRIEF:

# Mobilising development finance for economic growth and social impact

Poverty is rising for the first time in 20 years and COVID-19 threatens to reverse the development advances of recent decades. Yet funding for development assistance globally is in crisis: there is a USD 4.2 trillion dollar shortfall in financing required to support the achievement of the Sustainable Development Goals (SDGs) by 2030, and this gap is only widening as poverty rises while development financing stagnates.<sup>1</sup> Australia must use all forms of development finance to invest in human development, deliver on our commitment to the 2030 agenda, and support a clean energy transition in the Indo-Pacific region.

## KEY POINTS

- Amid rising sovereign debt, widening inequality, and the ongoing health and economic effects of COVID-19, a move towards innovative development financing has never been more timely or important in the fight to reduce poverty and enable inclusive and sustainable development.
- Grants remain core to the delivery of development programs and should increase, but public funding alone cannot bridge the widening financing gap. Australia must mobilise all forms of development finance, including blended finance, to achieve the sustainable development agenda. Maximising development impact must be the primary objective of all development finance initiatives.
- As experienced and knowledgeable development actors, NGOs are well-placed to contribute to public-private investments which aim to drive inclusive economic growth and generate positive and sustainable social and human development outcomes.

## RECOMMENDATIONS

1. Include the breadth of development finance mechanisms across both ODA and non-ODA funding in a new long term development policy (see ACFID's policy brief *Development at the Heart of Foreign Policy*).
2. Establish a standalone Development Finance Institution to bring together Australia's existing development finance initiatives under 'one roof', which would enhance strategic coherence, reduce fragmentation, and centralise expertise across government to lead and manage innovative development finance mechanisms.
3. Reinvigorate Australia's strategic approach to development finance by:
  - Putting development impact as the overarching objective of all development finance initiatives.
  - Improving the transparency and accountability of development investments, including ensuring a clearer articulation of ODA and non-ODA development finance in the budget papers, and regular public reporting of all ODA and non-ODA investments that support development outcomes.

## RECOMMENDATIONS

- Anchoring performance measurement (including monitoring, evaluation and learning activities) to the overarching objective of sustainable and inclusive development.
  - Adhering to the OECD Development Assistance Committee Blended Finance Principles.
4. Expand the Emerging Markets Impact Investment Fund (EMIIIF) by creating new investment windows of \$50 million for NGO-led impact investment funds and \$50 million to support clean energy transitions and climate financing.
  5. Include NGO and civil society partners in Australia's development finance strategy and programs, leveraging their interests, capabilities, and experience in investment-based approaches to development.
  6. Legislate ODA to be a minimum of 0.5 per cent of GNI by 2025-26 and 0.7 per cent of GNI by 2029-30.
  7. Australia should ensure that loans do not add to the debt burdens of Pacific countries including instating a moratorium on debt repayments.

## THE FINANCING GAP: NEEDS ARE RISING WHILE FUNDING DECLINES

There is a globally recognised need to mobilise new forms of development finance to achieve the SDGs and deliver on global climate agreements.

In the Indo-Pacific, the economic growth that fuelled development gains over the past two decades is waning, and poverty is expected to rise for the first time in a generation. This shifting economic landscape is both a cause and a consequence of increasingly complex and contested geopolitical dynamics. In this environment, Australia must pursue high-impact development finance modalities and work in partnership with our neighbours to promote inclusive and sustainable economic growth. In the Pacific, many countries are facing unsustainable levels of debt. Not only is this a risk to economic recovery itself, the need to service debt obligations also detracts from the ability of governments to fund services which meet the needs of their citizens. This raises questions about the viability of sovereign lending to support development in the Pacific.

In South East Asia, the needs are somewhat different. With stronger and more formalised markets and economies, many countries offer fertile ground for public-private investments in projects which will support economic recovery and achieve inclusive social impact. Human development – tangible gains in people's everyday health, safety, and wellbeing – must be the overarching objective of Australian investments in regional development.

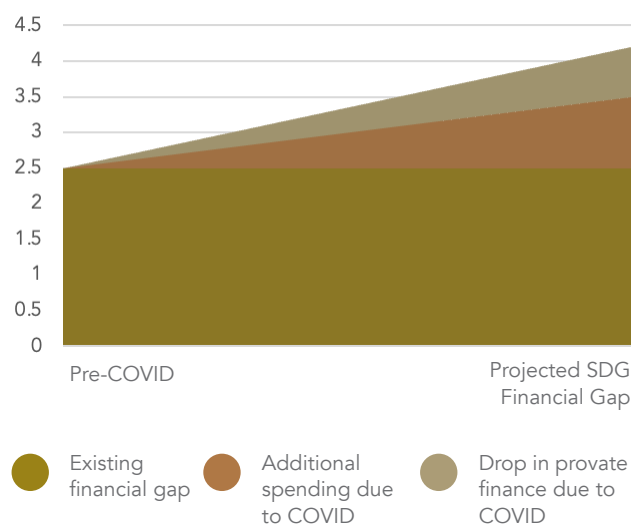
Investment-based approaches are also pivotal to addressing the effects of climate change and achieving a net-zero transition. Most countries have committed to net-zero by 2030, but will need help financing this transition.<sup>2</sup>

Private sector involvement is pivotal to the region's shift towards clean and renewable energy, but the financial risks are currently too high for a purely market-led approach to be viable.

Australia and other donors have an important role in 'crowding in' private sector capital to finance the development of clean energy, sustainable agriculture and forestry, and efficient, sustainable transport and technology across our region.

Governments and communities are grappling with the health, economic and social impacts of COVID-19. The widening gap in financing required for developing countries to achieve the SDGs threatens not only the global COVID-19 recovery but our ability to reduce poverty and ensure inclusive and sustainable development globally. Analysis by the OECD shows that the SDGs financing gap (estimated at several trillion dollars annually even before the pandemic) is set to rise by 70 per cent during

Figure 1: SDGs Financing Gap



Source: OECD, Global Outlook on Financing for Sustainable Development, 2020.

the COVID-19 pandemic. This would bring the financing gap from USD 2.5 trillion to USD 4.2 trillion annually. The increase is largely due to the additional needs created by COVID-19 spending, and a significant fall in private finance such as portfolio investments, foreign direct investment and remittance flows to low-income countries.<sup>3</sup>

In 2021, net ODA among OECD DAC members was just over USD 178.9 billion (4.26 per cent of the USD 4.2 trillion shortfall described above).<sup>4</sup> Even if all OECD countries were to meet the development assistance target of contributing 0.7 per cent of Gross National Income (GNI) today, total ODA would likely not exceed USD 400 billion per year. Evidently, there is not enough public funding to close this gap. Rising debt distress means that sovereign loans are not a viable solution. Aid grants are important, but far too small to fund the scale of work required. But this does not mean the task is impossible.

It would take a mere 1.1 per cent of total global finance (currently estimated at USD 379 trillion) to fill the SDGs financing gap.<sup>5</sup>

Development donors such as Australia must leverage private capital if we are to achieve the global sustainable development agenda.

There are many benefits to increased private sector involvement in development cooperation. However, investment must be managed, transparent and accountable. It is especially important that governments ensure public-private development investments do not stray from their overriding objective of delivering development impact. As experienced and knowledgeable actors in international development, NGOs and civil society are crucial partners in this effort.

## EXISTING PROGRAMS AND APPROACHES

Australia has a history of supporting multilateral development finance initiatives and granting concessional loans to neighbouring countries.

### THE AUSTRALIAN INFRASTRUCTURE FINANCING FACILITY FOR THE PACIFIC

In 2018 the Australian Government launched the Australian Infrastructure Financing Facility for the Pacific (AIFFP), which seeks to finance infrastructure investment across energy, water, transport, and telecommunications, as part of the wider Pacific Step-Up. The initial budget for AIFFP included AUD 500 million in grants (from ODA) and \$1.5 billion in 'callable' loans, managed by Export Finance Australia. The 2022-23 Budget increased the AIFFP's lending capacity to \$3 billion.

The publicly-stated overarching objective of the AIFFP is "to advance Australia's national interests" by contributing to the development of the Pacific. This is a notable difference from development-oriented financial institutions in other countries, which place development impact as their overarching objective, and actively work to separate donors' interests (whether financial, geopolitical, or otherwise) from investment decision-making.

While the AIFFP has approved a range of projects (including the refurbishment of Fiji's Nadi Airport,

a telecommunications cable project in Timor-Leste, and a solar plant in Papua New Guinea's Morobe Province), it is not investing as much as it was anticipated to, and it is unclear whether there is a healthy pipeline of 'bankable' projects.

While loans can offer useful means of supporting infrastructure development, given rising levels of debt distress across the Indo-Pacific they can also be a double-edged sword. In Fiji for example, public debt is projected to increase by 91.6 per cent this year, up from 48 per cent in 2019.

With COVID-19 wreaking economic havoc and increasing government borrowing and spending in an already debt-vulnerable region, the Pacific response is clear: "We don't want more debt financing."<sup>6</sup> Without sufficient grant capacity to enhance the concessionality of AIFFP loans, or parallel investment in social infrastructure to support inclusive and equitable economic recovery, Australia risks compounding Pacific debt burdens and detracting from the ability of Pacific governments to fund essential services and social protection programs in the region.

Australia has begun trialling blended finance approaches as part of our development cooperation program. The Emerging Markets Impact Investment Fund (EMIIF), for example, uses loans, equity and guarantees to ‘crowd-in’ private investment, to back fintech platforms or venture capital funds that are supporting small and medium enterprises (SMEs) in the Indo-Pacific region. DFAT’s Investing in Women program focuses particularly on women’s economic empowerment by providing grants to catalyse private investment in women-owned SMEs in Indonesia, Vietnam, and the Philippines.<sup>7</sup> The Australian Government also contributes to multilateral fiscal support, debt relief initiatives and programs that help partner countries foster a strong enabling and regulatory environment for business and investment.<sup>8</sup>

Investment-based approaches to development are also a growing area of practice within the NGO sector (examples of these initiatives are detailed below). An important comparative advantage for NGOs is their connection to local communities and their experience and expertise in development programming. This gives NGOs deep understanding of social challenges, and the ability to sense-check entrepreneurial and commercial approaches which seek to address these challenges. Development finance is criticised as often being ‘top down’ and reflective of the business interests of donor countries or private organisations, rather than the needs of local communities. Ensuring investment approaches are tailored to local contexts is important for development impact and, ultimately, financial sustainability. Given their development expertise and established relationships with local communities, NGOs are important partners in development finance ventures.

## PUBLIC FINANCE MODALITIES FOR DEVELOPMENT

	ODA	SOVEREIGN LOANS	BLENDED FINANCE
<b>Definition</b>	ODA is government aid delivered by official agencies, often in the form of grants, which “promotes and specifically targets the economic development and welfare of developing countries.” (OECD)	A sovereign loan is a loan made by a bank or financial institution, such as the World Bank or a registered lender to a foreign government, often the government of a developing country.	Blended finance is the use of catalytic capital from public or philanthropic sources to increase private sector investment in sustainable development.  Blended finance often includes ODA, but not always. Whether or not blended finance is classified as ODA depends broadly on the accounting method chosen by the donor, the level of concession of the public contribution, and the country that it’s used in.
<b>Australia’s current approach</b>	<p>Australia’s ODA allocation in FY20-21 was 4.56 billion (including “temporary and targeted” measures).</p> <p>In FY21-22 Australia’s ODA is estimated to reach just 0.21 per cent of GNI and, on current projections, will fall to an estimated 0.18 per cent in FY24-25.</p> <p>Australia currently ranks 21 out of 29 OECD economies for ODA as a percentage of GNI – below the UK (0.7 per cent), Canada (0.31 per cent) and New Zealand (0.27 per cent); well below the OECD donor average (0.32 per cent); and even below that of smaller economies such as Hungary (0.27 per cent) and Spain (0.24 per cent).</p>	<p>Australia currently provides sovereign loans to support development activities in other countries through:</p> <ul style="list-style-type: none"> <li>– Direct bilateral loans to Indonesia and Papua New Guinea</li> <li>– Concessional loans through the Australian Infrastructure Financing Facility for the Pacific</li> </ul> <p>Australia is also a shareholder of multilateral financial lending institutions such as the Asian Development Bank, the World Bank, and the International Finance Corporation.</p>	<p>Bilateral schemes funded by the Australian Government include:</p> <ul style="list-style-type: none"> <li>– The Emerging Markets Impact Investment Fund aims to provide technical advice and direct finance (such as loans, equity and guarantees) to help small and medium enterprises to grow.</li> <li>– Investing in Women uses grants to catalyse private investment in women-owned small and medium enterprises in Indonesia, Vietnam, and the Philippines.</li> <li>– The Australian Climate Finance partnership (announced March 2021) is an Australian Government initiative with the Asian Development Bank providing up to \$140 million to accelerate private sector investment in low-emission, climate-resilient solutions for Pacific Island countries and Southeast Asia.</li> </ul> <p>Australia also contributes to the following multi-donor or global networks for blended finance: Convergence (\$3.5 million), the Private Infrastructure Development Group (\$54 million since 2012), and the Private Financing Advisory Network.</p>

## EXPANDING AUSTRALIA'S DEVELOPMENT FINANCE CAPABILITY

Strengthening Australia's development finance capability must be prioritised as an essential aspect of Australia's future development policy.

The Australian Government currently funds a range of worthwhile investment-based initiatives, but these are spread between various divisions and agencies, which is limiting the efficiency and impact of Australia's overall development finance capacity. Australia should bring together these projects and programs to enhance coordination, build capability and ensure the long-term durability of Australia's development finance agenda.

A light-touch fix might be to establish a central coordinating office within DFAT with responsibility for setting development finance strategy, providing expert advice to programs, ensuring oversight and accountability, and undertaking monitoring, evaluation and learning across the portfolio.

A more purposeful and effective option would be to establish a standalone Development Finance Institution (DFI). Many OECD DAC donors, including the US, Canada, the UK, Germany, and France have established DFIs, which provide a range of services to support private sector engagement in developing countries. In general, these are independent government-owned financial institutions that apply private-sector management principles and tools towards investments to advance development objectives. Often, DFIs are the 'first movers', and underwrite projects, or invest in pilots or testing in specific industries. They can provide equity, mezzanine financing or direct lending, as well as insurance and guarantees. Important lessons can be learned from Australia's own experience trialling blended finance initiatives, as well as DFIs in other countries (see table below).

Whichever method it chooses, Australia must scale up our use of blended finance as part of our future development finance strategy. Increased use of blended finance approaches makes financial sense and would be consistent with one of the four tests set out in the 2017 White Paper for Australia's aid program, to "deliver results and value for money". In the UK, British International Investment (formerly known as the Commonwealth Development Corporation) has an average annual return of 6.1 per cent annual return while building its portfolio to £7.1 billion from £2.0 billion over just 15 years. The US International Development Finance Corporation (established in 2018 by merging the former Overseas Private Investment Corporation (OPIC) and the Development Credit Authority of USAID) has consistently returned funds to the Treasury and has a total exposure of USD 29.7 million through investments in low- and low-middle income countries.<sup>9</sup> The DFC estimates that earns USD 8 for each USD 1 of taxpayer funding invested.<sup>10</sup>

Using public finance to leverage or catalyse private investment can enable Australian ODA to achieve stronger development outcomes and more efficiently. Moreover, using blended finance modalities for some projects will free up ODA budget for projects that are best delivered using grant-based funding (such as social infrastructure). Australia should expand and diversify our use of this approach, in line with the OECD DAC principles and guidelines on blended finance. Importantly, Australia must ensure that our investments adhere to Principle 1, which focuses on the need to anchor blended finance use to a development rationale: "All development finance interventions, including blended finance activities, are based on the mandate of development finance providers to support developing countries in achieving social, economic and environmentally sustainable development."

This combination of maximising impact *and* value is why blended finance is a growth area for many OECD development donors. Last year both the UK and the US revamped their DFIs to place greater emphasis on development impact and climate financing. Both are also taking a closer focus on development needs and opportunities in the Indo-Pacific region. Establishing a DFI, or at least improving coordination of existing development finance initiatives, will help Australia to keep up with donors who are investing in the development of our region.

## CRITICAL ELEMENTS TO EXPANDING AUSTRALIA'S DEVELOPMENT FINANCE FOOTPRINT

Based on the lessons learned from other single-donor DFIs and Australia's existing blended finance initiatives, the following factors have been identified as critical to the success of an Australian DFI.

A clearly defined purpose and objectives	A DFI should have poverty reduction and human development as its overarching objective. Projects could take a particular focus on climate change mitigation and adaptation, renewable technology, gender inclusive development and agriculture.
Ensuring catalytic potential of investments	Catalytic capital investments by governments must be sufficient to massively scale up private sector investment. In the past, some DFIs have not provided enough initial capital to make investments attractive to the private sector.
Balancing risk and effectiveness	The Australian Government must ensure that its risk appetite enables calculated risk taking in backing new ventures or projects. Given that the role of a DFI is to be a 'first mover', governments must accept that there is an inherent risk calculus in blended finance approaches to development.
Building and showcasing development and financial expertise	Enabling confidence and increasing the risk appetite of investors requires harnessing and showcasing expertise within development finance, not just in private sector skillsets, but also development expertise.
Supporting investment decision-making	Governments must have the capacity to fund the core costs for investigating and running due diligence on potential projects prior to seeking private investment. There must be safeguards and other mechanisms in place to provide certainty and confidence to investors.
Acting as an efficient and effective pipeline	A DFI should have a range of modalities through which to match projects to the right kinds of investment, whether this is through core-cost funding, bundling, or providing multi-year funding to give each project its best chance of success.

## CIVIL SOCIETY ENGAGEMENT IN DEVELOPMENT FINANCE

Building upon decades of experience in non-grant aid such as microfinance, NGOs are scaling up their use of investment-based approaches to finance development and poverty alleviation. Over recent years, organisations such as Save the Children, The Fred Hollows Foundation, Good Return and World Vision have established impact investment programs to promote the growth and financial sustainability of SMEs.

Save the Children's Impact Investment Fund provides loans and equity investments to help start-ups and social enterprises grow.<sup>11</sup> With a particular focus on edtech, fintech and e-health, the Fund invests in enterprises aligned to the organisation's mission to improve the lives of under-served children and families. Good Return's Impact Investment Fund focuses on making agricultural value chains more inclusive across the Asia-Pacific, working with in-country financial institutions to leverage funding for SMEs, with

a particular focus on the inclusion and empowerment of women.<sup>12</sup> Similarly, VisionFund raised \$20 million in 2019 with its microfinance bond issue as capital for its microloans, micro saving and microinsurance services, with the aim of lifting families and children out of poverty.<sup>13</sup> The Australian Government should create an investment window within the EMIF portfolio of \$50 million to expand on this strong track record of INGO-led impact investment funds contributing to social and economic development across our region.

Moreover, consultation with civil society organisations should be incorporated into the structure of all new investment-based approaches to development. Civil society organisations and NGOs are experienced and knowledgeable actors in the development landscape. They have close connections to the communities in which they work, are skilled in program design and management, and

have significant expertise in accountability, monitoring and evaluation of development projects. NGOs are particularly well-placed to advise on how to leverage opportunities to support vulnerable communities, minorities, and women and girls. Development finance will not promote sustainable and inclusive development unless inclusion is explicitly prioritised at all stages of the investment – from program

design to implementation. This requires involving and empowering development actors who have experience working with local communities and vulnerable people and families. These are essential capabilities for the achievement of development outcomes and must be elevated in all investment-based approaches to development.

## SUSTAINING ODA

Despite the proliferation of new models for financing development, ODA remains the most important source of funding for development across our region and globally; for least-developed countries it comprises over two-thirds of external financing.<sup>14</sup> As articulated in ACFID's policy brief, *Development at the Heart of Foreign Policy*, Australia's current development budget settings do not reflect our changing strategic circumstances, our regional and global interests, or our values.

Despite recent temporary increases made in response to COVID-19, Australia's development cooperation budget, measured both as a share of national wealth over time and compared with other OECD donors, has remained at historic lows over the last several years. A new development policy must include legislated, stepped targets for achieving the 0.7 per cent ODA of GNI by 2030 target that Australia has agreed to as a signatory to the SDGs. This should include a legislated commitment to reaching 0.5 per cent ODA of GNI by FY25-26 as an interim target, and 0.7 per cent by FY29-30.

## ALLEVIATING DEBT DISTRESS

Sovereign debt is a significant and increasing challenge across the Indo-Pacific region. According to the risk ratings of the IMF and Asian Development Bank, 10 countries in the Pacific are already in high or moderate debt distress. The Asia Development Bank's Pacific Economic Monitor (December 2021) anticipates that public debt will rise by more than 30 percentage points of GDP in the Cook Islands, Fiji, and Palau, largely due to increased spending to support health and economic measures and collapsing government revenues. Moderate increases in public debt ratios are also projected in Papua New Guinea, Samoa, Solomon Islands, Tonga, and Vanuatu.<sup>15</sup> This reflects the looming debt crisis globally: 40 per cent of low-income countries are either already in debt crisis or highly vulnerable to one. This is twice as many as only five years ago.<sup>16</sup>

The Australian Government must play an active role in reducing indebtedness. To alleviate debt distress, Australia should instate a moratorium on debt repayment for the Pacific. This could include conversations between development donors and partner countries regarding debt for climate/health/education swaps to help alleviate debt distress in the Pacific. Australia's ODA should also not contribute to rising indebtedness. In providing loans to our neighbours, including through the AIFFP, the Australian Government must ensure it is providing sustainable loan-financing that does not exacerbate debt distress in our region or detract from the ability of governments to fund essential services and social protection for their populations. These bilateral engagements should also involve consultation with local civil society to ensure measures address rising poverty and inequality and support a resilient region.

Where loans are unavoidable, they should be highly concessional, with favourable and significantly reduced repayments. Debt swaps can be effective if designed well and in consultation with civil society. Australia should exert all efforts to ensure that external loans do not add to the debt burdens of Pacific Island countries.

## ENDNOTES

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