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**New Roads to**

**Development**

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## Preface

The Nordic business sector holds extensive expertise in investment and business development. This expertise could be better utilized in the effort to develop the private sector in developing countries. To increase the contribution of the Nordic private sector to growth and prosperity in developing countries, in September 2010 the Nordic Development Finance Institutions (DFIs), namely Swedfund (Sweden), Finnfund (Finland), Norfund (Norway) and IFU (Denmark), launched a Nordic advisory council for sustainable economic development.

The Council consists of:

- Kjell Magne Bondevik, former Prime Minister of Norway and President of the Oslo Center for Peace and Human Rights (Chairman)
- Anne Brunila, Executive Vice President, Corporate Relations and Sustainability, Fortum
- Hans Dalborg, Honorary Chairman, Nordea AB
- Christian Rynning-Tønnesen, President and CEO, Statkraft AS
- Sten Scheibye, Chairman, Novo Nordisk AS

The Council has the following mandate:

- I. To advise on how development policies in the Nordic countries can better facilitate and encourage private investments in developing countries, and not only the large emerging economies.
- II. To explain to the private sector the potential market for investments in developing countries, and why and how allocating more resources to such investments makes sense for a larger group of companies than are presently engaged in poor countries.

The Nordic institutions engaged Professor Pontus Braunerhjelm and Mr Jannik Lindbæk to prepare a background report in order to provide a deeper insight into these issues. The report "New Roads to Development: How DFIs can contribute to private sector development and growth in poor countries" is enclosed. Braunerhjelm is a professor of economics at the Royal Institute of Technology and Managing Director for the Swedish Entrepreneurship Forum. Jannik Lindbæk is a graduate of the Norwegian School of Economics in Bergen and was formerly CEO of NIB, EVP of IFC, and Chairman of Statoil ASA and DnB ASA.

The Council is pleased to present the following statement and recommendations based on the analysis of the background report.

## Statement

Sustainable poverty reduction will not happen without economic growth – no country has ever achieved lasting improvements in living conditions without economic development. The strong correlation between per capita income and social indicators such as lower infant mortality and higher life expectancy highlights the essential role of economic growth in social development.

During recent decades large parts of the world have seen unprecedented economic growth rates, and the number of poor people has been greatly reduced. According to the World Bank, the percentage of people who live in extreme poverty was halved between 1981 and 2005. Emerging developing countries are beginning to catch up with the living standards of the affluent, with China and India as the best known examples. Growth in these countries has lifted hundreds of millions out of poverty. Even many countries in Africa have now experienced a decade of high growth and reduction in absolute poverty.

The crucial question from a development perspective is what we can learn from the countries that have succeeded, and how we can use this knowledge to bring growth to a wider group of nations, notably those in Sub-Saharan Africa and other least developed countries.

One common denominator for successful countries has been increased investment in the private sector. This has happened partly through Foreign Direct Investment (FDI) and technology transfers from more advanced economies, and partly through domestic savings. There is a growing recognition that economic growth and poverty reduction has to happen primarily through commercially oriented private sector operations and development.

In addition to investments in the private sector, public sector investments are essential, supporting the development of education, health, transport systems and other infrastructure. A robust public sector supports the growth of private businesses by creating an enabling environment with a well-functioning legal and regulatory structure and by providing an educated workforce.

In essence, developing countries must go through the same transition as European countries did fifty to a hundred years ago and as Southeast Asia has done in the last few decades, reducing poverty through economic growth. In the Nordic countries this growth was achieved through market-friendly institutions, prudent legislative frameworks, strong emphasis on education, and development of infrastructure such as energy and transportation, with a good mix of private and public ownership. In the BRIC countries, the outstanding growth started with the modernization of agriculture and subsequent industrialization, including the building of infrastructure and communications. Based on their economic growth, they were then able to raise the standard of living and build a welfare system.

### **Need for a more balanced development policy mix**

Development assistance has delivered strong improvements in democracy, human rights and education, and performs life-saving tasks such as providing food, clean water, basic shelter and health care. It has created many of the preconditions for growth. But most developing countries have still not been able to build their private sector to a sufficient degree, create jobs and deliver the economic growth that is essential to alleviate poverty on a long-term basis.

For instance, more and more educated young people are entering the labour force in developing countries, thanks to improvements in their education systems. However, owing to a weak private sector, job opportunities are limited. The lack of focus on income generation and private sector development has also made it difficult for most developing countries to finance sectors like health and education, and thus created a deep aid dependency in their public budgets.

Market access for developing countries is another important element of development policies. But the situation is that many developing countries, and particularly the least developed countries, simply do not have the production capacity to utilize export opportunities through existing trade systems such as the WTO. Neither do they have a private sector strong enough to develop their production capacity.

What is needed is a more balanced policy mix of more traditional development assistance and private sector development. Development assistance should continue its support to human rights, democracy, health and education. The challenge now is to increase foreign direct investment, bring in capital and competence and build profitable and sustainable businesses and jobs.

### **Recommendations to policymakers**

The major challenge for the Nordic countries is how to encourage and facilitate more Nordic private sector companies to invest in developing countries.

The Council recommends that Nordic development policies be reviewed in order to:

1. **Invest in information.** Opportunities for doing business in developing countries have improved rapidly but unevenly. A lack of reliable information discourages investment or leads to poor investments. Better information would allow companies to select the best options and be more successful, thereby encouraging even more investment. Nordic policymakers should consider whether Nordic development cooperation could do more to facilitate access to relevant sectorial or project-level information.

2. **Share and reduce risks.** High perceived risks are a major obstacle to investment in many poor countries. Many of today's private sector development schemes are export-oriented. Today, the need is for schemes that promote investment and reduce risk for foreign direct investments (FDI) and for the establishment of enterprises in developing countries.

Development Finance Institutions (DFIs) exist to share risks with investors and, to the extent possible, to reduce them. Their capacity to do so is limited by their capital. As lately the potential contribution of private investments to development goals has greatly increased, Nordic policymakers should consider increasing the capital bases of their development finance companies and exploring other ways to increase their capacity to share risk.

3. **Invest in infrastructure.** Poor infrastructure hurts companies, particularly smaller companies that cannot build infrastructure for themselves. Apart from often being profitable private projects in their own right, investments in infrastructure frequently create opportunities for other businesses. Nordic development policies should contribute to public and private infrastructure investments that help other businesses succeed. Flexible funding mechanisms should be available to provide for necessary infrastructure such as telecommunications, water, power and logistics.
4. **Support the development of private projects.** In most of the poorer developing countries there are few well described projects and enterprises to invest in, compared to the huge potential to develop new and profitable business. The Nordic support schemes should promote the development of new business activity by funding early stages in the project cycle when risks are often high. There is also need for more public-private partnerships that combine private ventures with complementary public-sector activities supported by development assistance.
5. **Use DFIs as key partners.** The Nordic development finance institutions (DFIs) have worked with hundreds of Nordic companies and invested with many other financiers in all parts of the developing world. They represent a unique resource that could be utilized more. DFIs can act as advisors for Nordic businesses and other actors who want to invest in markets where the DFIs have experience and competence. Where Nordic DFIs are not active themselves, they could utilize their international network of 15 European DFIs to identify financing opportunities for Nordic business. Bringing in DFIs as key partners would contribute to raising the standards of environmental and social responsibility, working conditions and corporate governance.
6. **Focus on what we do well.** For the Nordic countries to succeed in private sector development, we need to focus on what we do well and where we have special competence.

## **Business opportunities for the Nordic private sector in developing countries**

A key question is why the Nordic private sector does not invest more in developing countries. There are many reasons: Lack of information about opportunities and negative perceptions of risk are obviously important. Furthermore, the risks of investing in poor countries in general and in Africa in particular are perceived to be high or unknown. Additionally, the infrastructure in developing countries is viewed as weak and inadequate.

The Nordic Advisory Council notes how many of the developing countries have recently had remarkable economic performance. Some of the most notable positive developments are taking place in parts of Africa, where the private sector in many countries is flourishing. In the past decade six of the world's ten fastest-growing economies were in Sub-Saharan Africa.

Based on its observations, the Nordic Advisory Council would like to:

- Draw the attention of Nordic business to the dramatic economic growth and notable improvements in infrastructure, business climate, education, health, regulatory frameworks and political and economic stability in many developing countries. The strong economic growth is particularly evident in emerging economies in Asia and Latin America, but can also be found in many poorer developing countries in Africa. This creates new business opportunities.
- Encourage Nordic business to draw on the capital, expertise, network and knowledge of the Nordic DFIs in identifying and financing commercial and project opportunities in developing countries. DFIs can help provide information on the investment climate, the opportunities and real risks on the ground. They are often first movers, financing pioneering projects and generating information on what might work for others.

The Advisory Council sees an opportunity for both Nordic policymakers and enterprises to engage in a more ambitious programme of private sector development in developing countries, and invites all parties to consider its observations and recommendations.

Helsinki, Oslo, Stockholm, Copenhagen

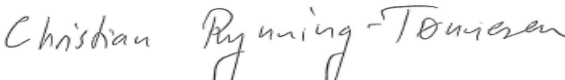
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# New Roads to Development

**How Nordic DFIs can contribute  
to private sector development  
and growth in poor countries**

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A background report for  
the Nordic Advisory Council  
for sustainable economic development

September 2011

## Foreword

The Nordic Development Finance Institutes (DFIs) have organized a Nordic Advisory Council with the task to elaborate on how the Nordic countries can better contribute to growth and prosperity in developing and emerging economies.

Based on an analysis of the challenges facing emerging economies, the current report provides a number of recommendations on how Nordic industry can contribute to enhanced and accelerated economic development. The critical issue in promoting growth and development is a sustainable and vibrant private sector development (PSD). The report centers around policy measures how to strengthen the foundation for such market dynamism.

The conclusions are of course our responsibility and do not necessarily coincide with those of the Advisory Council.

September 2011

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## 1. Introduction

The overriding question in development policy is how to best combat poverty and meet the Millennium Development Goals.<sup>1</sup> Although the public in the Nordic region still widely support aid, the impact and effectiveness of existing instruments and policies are increasingly being questioned.

After World War II a number of developing countries started with relatively similar prospects and possibilities. 50 years later we see the undisputed success of several East Asian countries contrasting with less or little progress in other regions. The most astonishing recent success is the strong economic growth and progress in China and a number of emerging market economies where over the last two decades hundreds of millions have been elevated out of poverty. Even many countries in Africa have recently experienced a decade of high growth and reduction in absolute poverty. In fact, among the ten countries displaying the strongest growth in the last decade, six are African. To a large extent these achievements can be attributed to a revitalized and expanding private sector, made possible due to internal institutional reforms (property rights, de- and reregulation, etc.), increased inward foreign direct investments and trade liberalization. Thus, policy changes have embraced both national and international areas.

The divergent growth paths across developing countries in the last decades imply that lessons can, and should, be learnt from previous successes and failures. Obviously, one crucial question from a development perspective is what can be done to replicate the Asian successes in a wider group of nations, notably in Sub-Saharan Africa and other least developed countries. Many of these poor countries start from a low level and would need to excel in growth rates for a long period of time to eradicate absolute poverty among their people. In the least developed economies many important markets are not functioning. The perceived risks are also high. There is therefore a need for multilateral and bilateral support to compensate for market failures.

Aid policies consist of several pillars where one refers to direct aid in times of urgent needs, a second has to do with building an enabling environment for economic growth and development while a third vehicle provides direct support to the private sector through

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<sup>1</sup> The prime goal is to reduce poverty by half 2015. See <http://www.un.org/millenniumgoals/>.

development finance institutions (DFIs). There are important multilateral DFIs, like IFC and EBRD. Among the OECD countries there are a number of national DFIs. The advantage having national DFIs is that they will naturally be different from the others, linked to their respective countries' industrial- knowledge base and comparative advantage. The multilateral and national DFIs also work together on individual projects, combining the competence and resources of different institutions.

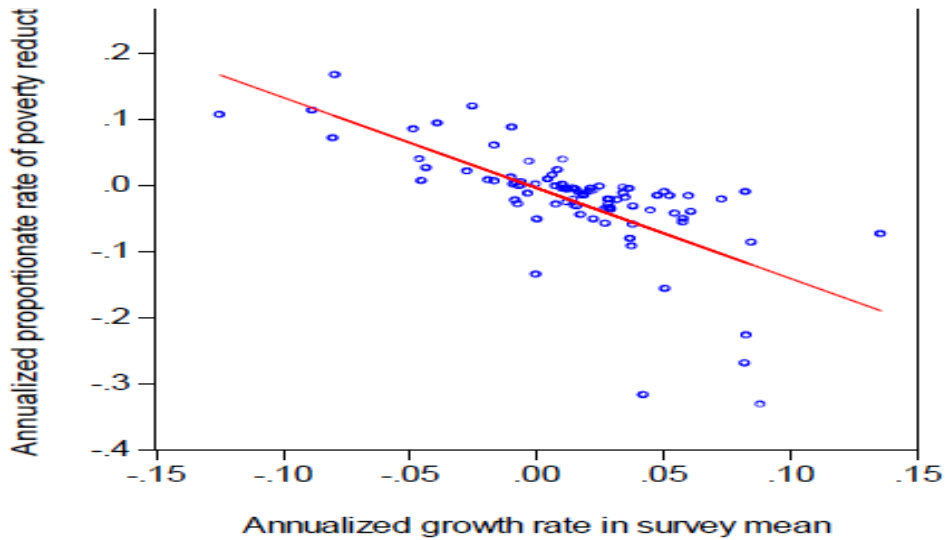
### *The role of the private sector in economic development and growth*

Poverty reduction is the overarching goal and it cannot be achieved without economic growth. Even though there is no simple explanation to the "mystery of growth", proper institutions that encourage private ownership and openness seem to be the most important explanatory factor. Other variables such as the size of the public sector, and even the level of human capital (with exception for basic education), give more ambiguous results according to the last 15-20 years of research (Sala-i-Martin 2002).<sup>2</sup> However, as illustrated in Figure 1, there is no doubt that there is a strong relationship between growth and reduced poverty (Ravallion and Chen 1997, Deininger and Squire 1998, Bigsten and Levin 2001).

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<sup>2</sup> Some of the most distinguished economists disagree about the future growth trajectory. Nobel laureate Lucas (2000) believes that per capita income will converge over time because good institutions will be copied whereas Nobel Laureate North (1990) is much more skeptical since institutional set-ups are driven by vested interest and traditions. Copying institutions have also been shown to fail (Easterly 2001). Bigsten and Moene (1996) claim that Africa's mediocre development up until the 1990s has to do with weak institutions and corruption.

**Figure 1. Poverty Reduction vs. Growth for 92 Countries, 1980 – 2005**



Source: Ravallion 2009

Note: Chart shows rate of change in \$2/day poverty for 92 countries based on earliest and latest household surveys available over 1980 to about 2005. Average years between surveys are 13.

Hence, irrespective of some notable exceptions (China in particular), history tells us that sustainable long-term economic growth cannot be achieved without a thriving private sector. But, the private sector will not flourish without a well-functioning public sector. The two sectors complement each other and there are areas where the public sector continues to have a primary role to play, such as institutional support, health, education and infrastructure.

Experience further shows that successful private sector projects have important ripple effects locally and regionally. In addition to the jobs created in the project itself there is important job creation through suppliers, partners, subcontractors etc. There is a multiplier effect showing that for every direct job created a number of other jobs are also being created.

Foreign Direct Investment (FDI) is a strong catalyst for development. It is therefore important for host countries to improve their ability to attract FDI. In addition to the capital invested in the project through FDI, it also normally entails transfer of technological and managerial skills. These skills are often lacking or in short supply in the host country. It is also important to reduce and eliminate obstacles to investment, including excessive bureaucracy

and corruption. Inward FDI also carries important signaling effects to other firms, foreign as well as indigenous.

One of the most severe constraints on economic development, particularly for the development of the private sector, is the lack of available and suitable domestic finance. Therefore the task of building well-functioning domestic capital markets is of critical importance. The underdevelopment of the financial sector has led to a situation where a large number of sound investment projects will never be realized for lack of financing.

Related to this is the real and perceived credit risk. The two main credit risk categories are political and commercial risks. Project sponsors often simply cannot raise needed amounts of project finance due to creditors' perception that these risks are unacceptably high. The long term goal for any country should be to build financial institutions channelling domestic savings to viable domestic investments. It continues to be an important task for DFIs and MFIs to assist in the establishment and growth of local financial institutions.

Hence, there are a number of challenges facing the developing world. This report will however focus on the role for private sector development (PSD) and how industrialized countries can contribute to a sustainable, market based growth process in developing countries. The report is organized in the following way. Chapter 2 gives a brief description of the evolution of development strategies while Chapter 3 is devoted to the lessons learnt, emphasizing the importance of the financial sector. The opportunities that have opened up in developing countries are presented in Chapter 4 and the role of the Nordic DFIs illustrated through case studies. The subsequent Chapter 5 portrays more in detail how the DFIs can contribute to economic development simultaneously as links to the business sectors in donor countries may be reinforced. The final Chapter 6 contains policy recommendations and suggestions how and why the Nordic countries' business sectors should deepen and intensify their commercial relationships with developing and emerging economies.

## 2. Background – a recapitulation of development strategies

During the second half of the 20<sup>th</sup> century global GDP six-folded (Maddison 2001), integration between countries deepened and yet immense differences in the global income distribution have not vanished. Laggards basically remained laggards and in many cases the gaps to leading countries even increased. The last few decades has however witnessed a change.

These differences across countries are what has prompted the interest in development economics, a research and policy field that has undergone considerable changes since the 1960s. In particular, the pendulum has swung from the critical role attributed the government in the 1960s and 1970s where grand scale governmental projects targeting specific sectors were expected to generate trickle down and growth effects in developing countries, to an increased emphasis on the role of the private sector in spear-heading economic development. In this chapter we will briefly review the turns that has characterized development policies in the last decades.

*From governmental planning to market driven development strategies: joining forces with the private sector*

PSD is far from a new insight; already back in 1987 the World Bank acknowledged the importance of early involvement by the private sector, concluding that “.....promoting private sector development is not an ideological necessity. It is sound policy”.<sup>3</sup> That summarized a position which began to become established in the latter half of the 1970s, partly influenced by a more general trend towards more liberal and market friendly policies and a diminishing role for governments. Today there is consensus about the important role for the private sector in promoting growth and sustainable economic development. However, it was not until the 1990s that PSD became more generally accepted as being a prime vehicle to attain economic development. The more fierce proponents of what has been labeled the development counter-revolution opted for considerably more radical policy changes such as complete laissez-faire trade and the termination of official aid.

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<sup>3</sup> See Braunerhjelm and Fors (1996) for a literature survey.



A first hint at rethinking development policies at the global level became obvious when the World Bank introduced the more market oriented Structural Adjustment Loans (SALs) schedules in the 1980s. These were conditioned on reforms undertaken in receiving countries. Still, also the SALs frequently failed to produce the desired economic effects and were even found to have some detrimental social effects. In the latter part of the 1980s the strict “economistic” approach to development received increasing criticism and was replaced by “Adjustment with a Human Face” launched by UNICEF. It was a moderated view of the previously dominating Washington Consensus, which centered on liberalized trade, macroeconomic stability and free markets.<sup>4</sup>

Thus, development thinking has arrived at a (new) Consensus in which both the state and the private sector have come to be regarded as essential for development and also for poverty reduction. It stands in sharp contrast to the 1960s and 1970s, but also compared with the 1980s. The present Consensus considers the private sector as the superior way to promote growth, while the state is allotted the task of ensuring an “enabling environment”, such that growth becomes more inclusive and extends also to the poor in society. Governmental aid is viewed as strategically important to develop the health, education and infrastructure sectors, as well as providing institutional support that are necessary for a thriving private sector development (Lloyd-Sherlock 2000, Bourguignon et al. 2001).

At the end of the 1990s the following two basic pillars were generally accepted as guidelines for aid and development policies. First, poverty reduction is the main objective of development, which requires growth to take place. Second, long-term sustainable growth can only be obtained through the private sector which is dependent on an appropriate institutional design which governments are responsible for.

In the last decade the effectiveness of traditional aid has increasingly been questioned. It is claimed to distort incentive structures within receiver countries and instead generate structures that have negative impact on budget discipline and tax revenues. Hence, it is argued that traditional aid provides low incentives to develop a proper institutional setting, thereby harming the prospect for economic development (“aid fatigue”). Opposing that view are those advocating that a considerable increase in aid-funded investment – a “big push” –

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<sup>4</sup> See Stiglitz (1998).

is necessary in order to turn a vicious cycle of underdevelopment to a virtuous cycle of shared economic prosperity.<sup>5</sup>

### *Openness and industrial policies*

The changing view on how to design development policies was largely influenced by the experiences of countries that had adopted strategies based on openness. The dominant development paradigm after World War II was import substitution, influenced by the export pessimism of the 1950s and 1960s, aiming at developing a modern industrial sector through government planning and protectionism. The result turned out to be quite devastating, which became particularly conspicuous by the sharply contrasting experiences of East Asia and Latin America. In the latter regions, high tariff and nontariff barriers were used to promote industrialization and growth in the period following World War II. However, the more successful East Asian countries abandoned a pure import-substitution strategy in the 1950s and 1960s in favor of policies promoting openness.<sup>6</sup> As a consequence, the importance of trade liberalization and deregulation to encourage inward foreign direct investment (FDI) was further stressed.

A number of general features of the export oriented approach are worth highlighting. First, government support was by and large given to firms according to their success in the market place, particularly world markets. Second, East Asian exporters had fairly uniform incentives for exporting across virtually all industries and activities, with varying degrees of import barriers. Third, free entry for imports providing inputs to the export sector appears to have sufficed to open the import sector significantly, in spite of trade barriers. The main effect of trade restrictions may have been to bias the composition of imports towards intermediate goods rather than final goods. However, East Asian economies were still able to benefit from technological spillovers associated with imports.

Yet, to varying degrees countries in East Asia also implemented interventionistic – albeit market oriented – measures such as export subsidies, selective import barriers and industrial policies. But they generally avoided the temptation to direct most resources to subsidize

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<sup>5</sup> See e.g. Ross (2004), Sachs (2005), Easterly (2006), Guillaumont and Guillaumont-Jeanneney (2006) and Moss et al (2006).

<sup>6</sup> Often involving the agricultural sector and also implying a redistribution of ownership (Mellor 1999, Bigsten 2003).

loss-making firms or to benefit well-connected rent-seekers. When tried, the outcome of industrial policy initiatives often did not turn out to be very successful. For example, in both Japan and Korea efforts to subsidize some industries in the 1970s turned out to be counterproductive and costly (Beason and Weinstein 1996). Interventionist industrial policy may shut out potentially successful firms and discourage innovation. For example, Japan's Ministry of International Trade and Industry (MITI) attempted to discourage individual firms that eventually turned out to be "winners" in international markets. Honda is a notable example. Thus, industrial policies may succeed in promoting certain types of firms but may discourage the type of innovation and entrepreneurship needed to achieve higher levels of development.

What is undoubtedly true is that efforts to "pick winners" have failed in most countries. Left on their own, private investors has an incentive to pick much more carefully than governments. Industrial policy appeared to be most successful when governments tried to "encourage" rather than "pick" individual winners to compete in world markets, with the marketplace being the ultimate arbiter of whether continued support of an industry was warranted.<sup>7</sup>

### *The role of the government*

What, then, can the government do? It is in no way sidestepped and one of the most important roles is to provide an economy with institutions that enhance welfare and fosters long-term growth, thereby paving the way for competitive and efficient market-based operation and ultimately prosperity. According to Acemoglu et al. (2003), the big divergence in development and incomes can be traced to the industrial revolution in the 19<sup>th</sup> century, where countries that imposed a market friendly institutional setup became the winners.<sup>8</sup> Hence, trustworthy rule of law is necessary to develop institutions that preserve social stability, but also in providing a framework for democracy, good governance and human rights.

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<sup>7</sup> Elements of the interventionist model continue to be favored by some recently emerging Asian economies, such as China.

<sup>8</sup> Hence, arguments related to the climate and similar factors, are dismissed. See also Sala-i-Martin (2002) who stresses institutions. North (1990) claims that there are considerable lock-in effects and slow changes in institutions. Krugman and Venables (1995) claim that geography – distance to demand and markets – matters.

More precisely, the following four areas have been defined where governments play a critical role:

- Providing macroeconomic stability, including government expenditures, price stability, rule of law, etc.
- Public investment in infrastructure, health and education using domestic savings and revenues, or together with other investors.
- Leadership and capable administration related to growth, the distribution effects of growth, transparency and accountability.
- Creating openness to allow knowledge and transfer and access to markets, thereby integrating the economy into a global context.

Elaborating somewhat on these four areas, it is obvious that economic development has been hampered due to an often volatile macroeconomic situation caused by frequent crises and a high rate of inflation, generating vicious circles of booms and busts. High inflation means little faith in the value of money, which affects savings in a negative way. It also will depress the value of the local currency. The result has been a number of financial or balance-of-payments crises in developing countries since 1975. These have resulted in huge losses and economy-wide dislocations.

Similarly, a great obstacle to longer term lending, besides a high rate of inflation, is the lack of reliable collateral security. The “dead capital” of real estate is well described by (de Soto 2000). There is important work going on in some countries creating reliable government land and mortgage registries, which can form the basis for collateral security and long-term mortgage lending.

It is also clear that corruption, non-transparent structures and protectionism are important deterrents to attracting private sector investment. Multinational companies normally have extensive choice as to where to invest. A high level of corruption, i.e. weak or non-existent rule of law, will make it less attractive to invest. A similar argument can be raised as regards entrepreneurial and innovative activities. Recently there has been an increasing focus on the importance of entrepreneurship, the growth of small and medium-sized business, as well as

innovation in fostering economic development.<sup>9</sup> Hence, a multi-faceted approach to economic development is required where the importance and complementary role of new enterprises, SMEs, as well as large firms, is acknowledged.

Governments should thus refrain from tasks or interventions which either jeopardized the functioning of the private sector or crowd it out. Thus, state intervention is only justified when markets fail (or would fail without proper supervision), or do not yet exist. Basically that implies a strategically critical role of the government.<sup>10</sup> Credible and just legal and regulatory framework, making sure that the necessary investments in infrastructure is undertaken and retaining macroeconomic stability can be defined as core tasks (see Box 1). Strengthening property rights is the single most important institutional element and has repercussion on costs of entry, exits and firm growth, access to capital, possibilities to insure against risks, and inflow of foreign capital and investments.<sup>11</sup>

#### **The importance of institutions: Singapore vs. Jamaica**

Both countries gained independence in the first half of the 1960s, 1965 in Singapore and 1962 in Jamaica. In terms of GDP per capita (in 2006 U.S. dollars) the countries were then on equal footing: \$2,850 in Jamaica and \$2,650 in Singapore.

Other conditions were also quite similar. Both countries were centrally located port nations; they had a tradition of British colonial rule and governments with a strong capitalist orientation. In addition, Jamaica had plentiful natural resources and a robust tourist industry.

Four decades later the differences are striking. In terms of GDP per capita Singapore had \$31,400 and Jamaica a mere \$4,800 per capita. Singapore is prosperous with a thriving and well-developed economy. Jamaica is trapped in hardship, low income and miserable living standards. According to Lerner (2010) the explanation is differences in the way institutions have formed since independence.

What accounts for the amazing difference in growth rates? Entrepreneurship and innovation one major ingredient (Lerner 2010)

<sup>9</sup> See UNDP (2004).

<sup>10</sup> See Bracking and Ganho (2011).

<sup>11</sup> See numerous studies based data from the World Bank's Doing Business data where the main institutional variables refer to starting a business, hiring and firing, getting credit, closing a business. Heavy regulation and high taxes encourage entrepreneurs and SMEs to operate in informal sector (Djankov et al. 2010).

*Private sector development - how to define it?*

How should the private sector in developing economies be defined? The term is often used by donors to mean something much broader than private business activity. While the latter lies at the heart of most of the definitions that donors use, precisely what the sector encompasses tends to be left somewhat vague. Unclear definitions create problems for clear policy formulation. The DAC defines the private sector as “a basic organizing principle for economic activity where private ownership is an important factor, where markets and competition drive production and where private initiative and risk-taking set activities in motion”. In addition, PSD can be “applied in all economic activities”. The fact that it is conceptualized as a basic organizing principle shows that the private sector is not simply confined to firms and enterprises, but is regarded as a way of ordering and structuring society.

The European Union’s definition of the private sector includes small and medium-sized enterprises, microenterprises and crafts, while at the same time covering both the formal and informal sectors. Definitions thus embrace everything from large factories to self-employment operating on a part-time basis. For some donors, not even ownership of the means of production is a decisive criterion for membership of the sector. This means that even state owned enterprises (if functioning on a market base) may be included.

PSD can also be defined with regard to the type of interventions undertaken. Basically, these refer to i) direct, project of firm based, ii) regulatory concessions, treaty exemptions and trade issues, support for start-ups or certain (export processing) zones, iii) indirect, targeting measures to infrastructure, financial sector, tax systems and other “beyond the firm” issues, iv) harnessing the private sector, influencing corporate structures and cultures, CSR, etc.

To summarize, PSD has increasingly been seen as a means to fight poverty and attain a number of economic, social and political goals (i.e. satisfying a broad range of human needs, creating plurastic societies, security, human freedom, etc.).

### **3. Efficient mechanisms to promote sustainable economic development – what do we know?**

Why do countries engage in foreign aid and development policies? Besides more altruistic reasons such as reducing long-term poverty and alleviating short-term catastrophes, there are also potentially import welfare effects for donor countries in expanding the global economy. As witnessed during the last decades, globalization implies increased competition for developed countries but it also implies opening up new market possibilities and enormous potential positive welfare effects in the somewhat longer run. Hence, it is also in the interest of donor countries to build capacities in less developed countries that will expand global economic opportunities. Market based strategies lie at the heart of such development and PSD can be seen as a key instrument to achieve this end.

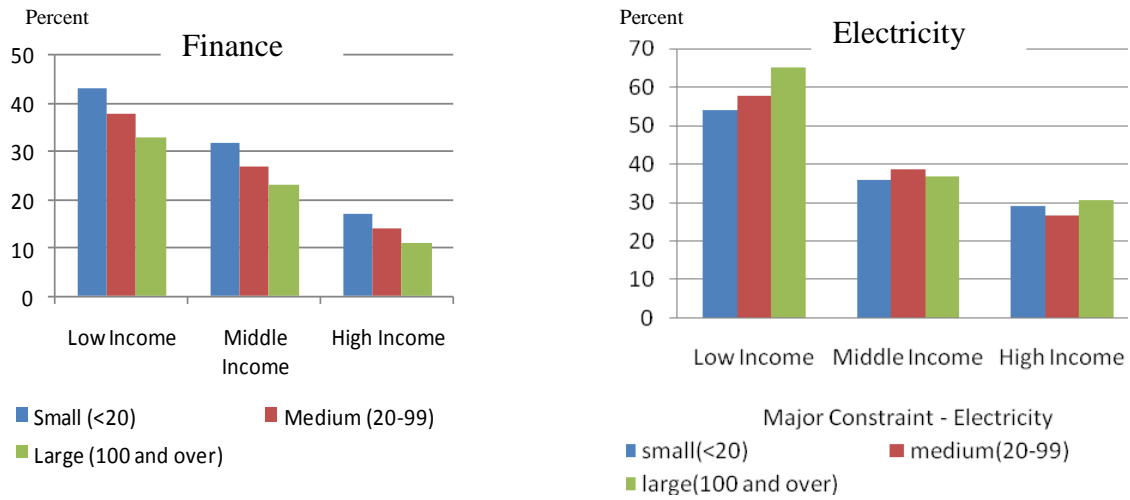
In order to obtain these objectives – and irrespective of type of policy instruments implemented to accelerate economic development – its effectiveness relies on professional governance and scrutiny undertaken by adequate and highly skilled expertise (Collier 2006). Also in the field of development economics and its practical implication, specialization is likely to favor professionalism. It is noteworthy that among receiving countries the main internal shortcomings used to be attributed to the business sector but now those of government policies are emphasized, notwithstanding that further upgrading of the business sector is still a valid objective.

As noted above an inadequate institutional design hamper industrial dynamics, generate suboptimal resource allocation and negatively impact economic development. On the other hand, an appropriate institutional design that favors property rights and credible legal systems, together with knowledge infrastructure (human capital and education), physical infrastructure (transports, power generation, etc) and a well-functioning financial sector, have been shown to spur economic development and prosperity.<sup>12</sup> As shown in Figure 2, most firms in low income countries view the lack of reliable access to electricity and suitable finance as the major obstacles for their operations. It is also within the sectors illustrated in Figure 2 that DFIs concentrate their efforts (Figure 3).

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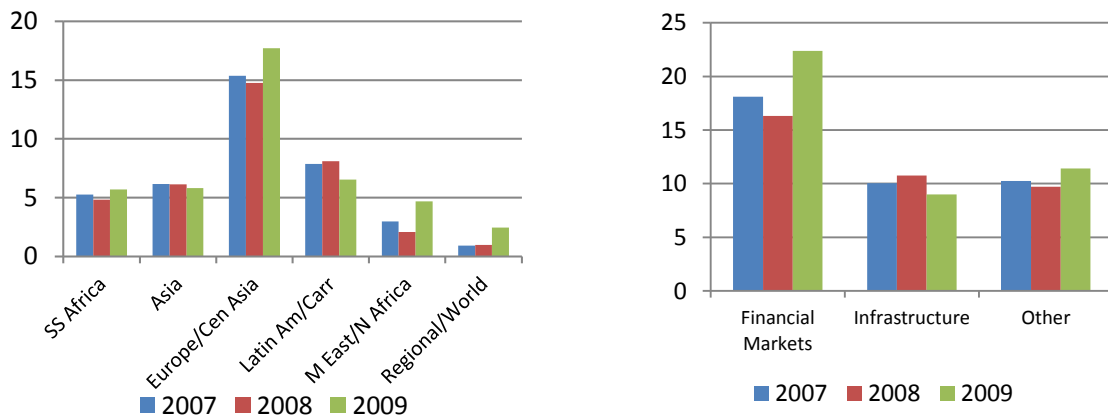
<sup>12</sup> See also Limao and Venables (2001) for a theoretical motivation.

**Figure 2. Percent of firms viewing access to finance and electricity as major obstacles**



Source: World Bank Enterprise Surveys

**Figure 3. DFIs commitments to the private sector in 2008-2009 by region and sector**



Source: World Bank Enterprise Surveys



*PSD and economic development: Lessons learnt*

The overarching objectives and expected outcomes of PSD is to expand market based capacities and industrial dynamics in receiving countries, in addition to promote knowledge spillovers that promote local community development. DFIs constitute one vehicle to bridge existing gaps between developed and less developed countries. They may contribute to reduce information asymmetries between firms within the receiving countries but also between firms in receiving and donor countries, correct market failures and generate signaling effects that can encourage others to invest.

PSD policies occur at several layers - from macro-level issues to those associated with micro- and firm levels. Generally bilateral donors concentrate their PSD interventions on the micro-level of PSD. More macro-oriented issues, such as providing a more enabling environment, tend to receive less attention. The rationale for interventions at different levels is frequently not well analyzed. Often the clearest and best worked out PSD programs are those that linkup with donor countries' own private sectors.<sup>13</sup>

Different means of development policies tend not to be entailed in a coherent framework, rather they are dispersed across different agencies and without a coherent strategy. In addition, the PSD programs of most bilateral donors are spread between several authorities and agencies, enjoying varying degrees of autonomy from the main development agency concerned. Greater streamlining of agencies and modalities has been claimed to be desirable in order to avoid duplication. One claimed weakness of PSD programs has been inaccurate coordination and cooperation between donors, and few links to poverty reduction. Given that poverty reduction is the long-term objective, it seems crucial that this also constitutes the lead motive for interventions and is coordinated with other efforts. A likely reason is that PSD funding has not always been paralleled by efforts to improve capacity building, setting guidelines, changes in administrative systems, etc., in receiving countries.

Finally, many PSD-related interventions seem to lack a point of departure in the real capacities, modes of operation and internal relationships found in private sectors, firms and

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<sup>13</sup> See Hansen (2010).

institutions in developing countries. Instead, interventions are usually based on models of business development derived from developed countries (Gatewood and Boko 2009).

Mainly three concerns have been raised with regard to PSD strategies which will be discussed below. These can be characterized as follows:

First, do DFIs crowd out investments by either other indigenous investors or by other investors in the donor countries? Basically there seems to be less of crowding out and more of crowding in as regards the effects of DFIs. In general, the extent to which effect that dominates has to do with policies pursued in receiver countries. If DFI activities take place in specially designated enclaves, and if less market friendly institutions are prevalent, then the positive effects tend to be reduced. These effects are both direct (employment, training, trade, etc) and indirect (spillovers, knowledge leakages, etc.) effects. PSD initiatives must clearly be market based in order to avoid subsidizing activities that would crowd out other private organizations and firms.

Second, how does PSD in general and DFIs in particular impact the integration of the private informal sector into the formal sector? The dominant effect seems to be positive but contingent upon the institutional setup in the respective country. A more market oriented economy with credible rule of the law is likely to induce a transfer of economic activity from the informal to the formal sector (de Soto, 2000).

Third, to what extent does DFIs entail elements of tied aid? In particular, are DFIs favoring their home country firms in their investment activities in an unjust way? Tied aid may in some countries still be a central feature of PSD-related initiatives. Since DFIs operate on more market based conditions, the risk of inserting negative effects through tying aid should be less pronounced. Moreover, the DFIs have good knowledge about the skills and expertise of the domestic firms they work with, and they may also convey knowledge to a much wider group of potential investors. In addition, bilateral and multilateral agencies tend to cooperate in projects, reducing the risk of tying resources to the home country. The number of active DFIs should entail some element of competition that also serves to mitigate such negative effects. Still, the overall share of tied bilateral donor aid shows no clear tendency to fall, and this may be related to the increased weight enjoyed by PSD (Schulpen et al 2001, Bracking and Ganho 2011).

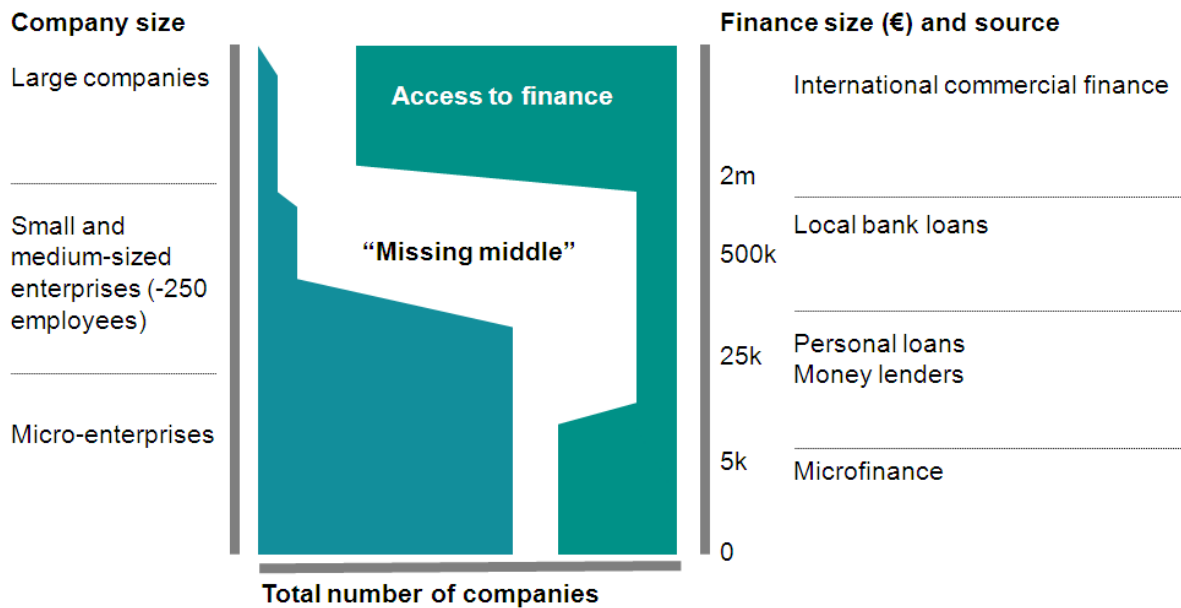
### *Financial market constraints*

One of the great constraints on economic development and particularly on the development of the private sector is the lack of available and suitable domestic finance. Therefore the task of building well-functioning domestic capital markets is of the highest importance. The underdevelopment of the financial sector has led to a situation where a large number of sound investment projects never will be realized for lack of financing.

Historically, less than 30 percent of investments in developing countries have been financed by cross-border loans and equity investments. The bulk of investments have been financed from companies' internal resources and from domestic institutions on terms that more often than not are onerous and unsuited. The three most common failings are that domestic loans cannot be obtained in large enough amounts needed to proceed with the investment; the loan maturities offered are too short compared with the productive lives of investments; and interest rates on the loans are much higher than what would be commensurate with objective risk analyses of borrowers and their projects. The medium-sized firms seem to be most severely hit by the problems related to obtaining finance (Figure 4).

Hence, the domestic financial system in most developing countries is not able to effectively transform local savings into sufficiently large pools of funds to finance economically viable investments. Projects will therefore often have to look for cross-border loan finance in a major foreign currency. The revenue earned by the project is normally in local currency. This creates a currency risk, which the project often finds it difficult to carry.

Another weakness is the lack of competition among banks, resulting in large lending spreads. This in turn leaves them with scant incentive to lend to new sectors and take on new types of risk such as giving longer-term loans. Banks operating in this type of environment will continue to offer companies short-term overdraft facilities and short-term trade finance. In addition, needed financial institutions and markets often simply do not exist. Most developing countries do for instance not have a bond market.

**Figure 4. The Missing Middle**

Source: Dahlberg 2010

The low risk taking capacity of lenders in domestic financial systems routinely extends to a weak ability also to guarantee commercial risks. Risk coverage must therefore often be obtained from abroad. The financial risk cover from abroad for developing-country commercial risk is however also limited, whether the loan to the project is from a domestic lender or from a cross-border source. IFC has developed a partial risk guarantee product for both local currency and international currency loans that will indemnify lenders up to pre-agreed amounts regardless of the reason for default, i.e., including all commercial risks. The larger DFIs in Europe, such as DEG and FMO have developed similar products.

Risks are further aggravated due to political upheaval, civil unrest, breach of government contract and other forms of political risk. There exist some sources of coverage for these risks. Traditional institutions like the OECD export credit agencies, export credit guarantee agencies, and MIGA provide loan and/or equity investment guarantees that private projects can use against expropriation, breach of contract, or similar adverse actions by a central government. The World Bank and the regional development banks also have programs to alleviate sovereign risk for lenders to public-sector projects in developing countries.

Many projects will have strong commercial ties to regional or local governments or to entities that are majority-owned by local governments, such as public utilities. The success of many projects depends on such sub-sovereign government entities fulfilling their contractual obligations to the project. An example would be a power project relying on an off-take agreement with a single government entity. Such projects would often find it necessary to rely on a third party guarantee to back up undertakings entered into by, for example, a local utility. Sometimes a guarantee from the utility's local government itself will suffice. However, most sub-sovereign governments are now extremely reluctant (or unable due to IMF restrictions) to offer guarantees to lenders.

There is a general lack of capacity to insure against non-payment due to breach of contract by government entities at the sub-sovereign level. The World Bank, the regional development banks, and MIGA have some capacity to offer guarantees for non-payment due to sub-sovereign risk. However, these institutions will require counter-guarantees from the host governments, a requirement that is hard to fulfill as host governments grow more reluctant over time to offer counter guarantees. IFC has a small program offering guarantee cover for loans to sub-sovereign entities. IFC will assume the risk on the sub-sovereign entity and will not require a sovereign counter guarantee.<sup>14</sup>

The long term goal for any country should be to build financial institutions channeling domestic savings to viable domestic investments. It continues to be an important task for DFIs and MFIs to assist in the establishment and growth of local financial institutions. We believe the whole area of risk alleviation should be examined more thoroughly.

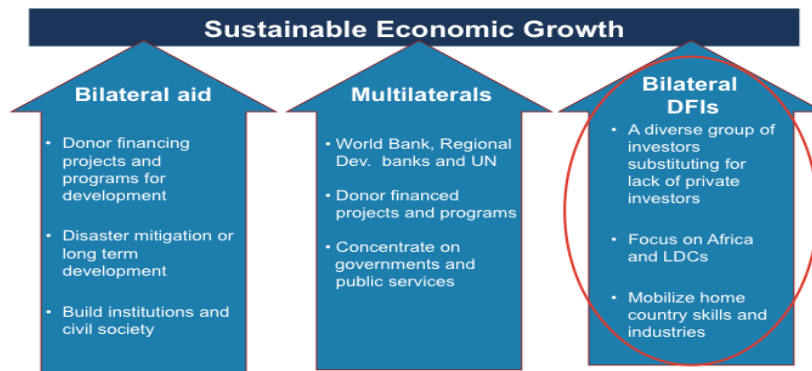
To summarize Chapter 3, the rationale for increased private sector involvement in developing countries thus seems clearly demonstrated and evident. Private sector should do

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<sup>14</sup> The experience from Norway with GIEK (the Norwegian institute for export guarantees) is that they are in general easy to work with and interested to offer guarantees. However, GIEK is restricted by the Norwegian export content rules as well as a desire to stay safely within the OECD rules. When it comes to loan guarantees, there is usually inadequate Norwegian content to trigger a GIEK guarantee. When it comes to investment guarantees (i.e. to cover equity against political risk), this is often available, but limited to traditional political risks as mentioned above. We are aware of work going on at present time in Norway with consultants having been hired to identify the gaps of coverage. Perhaps this could lead to a discussion about new instruments and vehicles.

what it does best: to create growth and income and bring about sustainable economic and social development. Hence, as illustrated in Figure 5, properly governed DFIs has increasingly been seen as the third pillar in development policies which complements traditional aid (bi- and multilateral) and multilateral financial services (loan, grants, guarantees).

**Figure 5. DFIs as the third pillar of development**



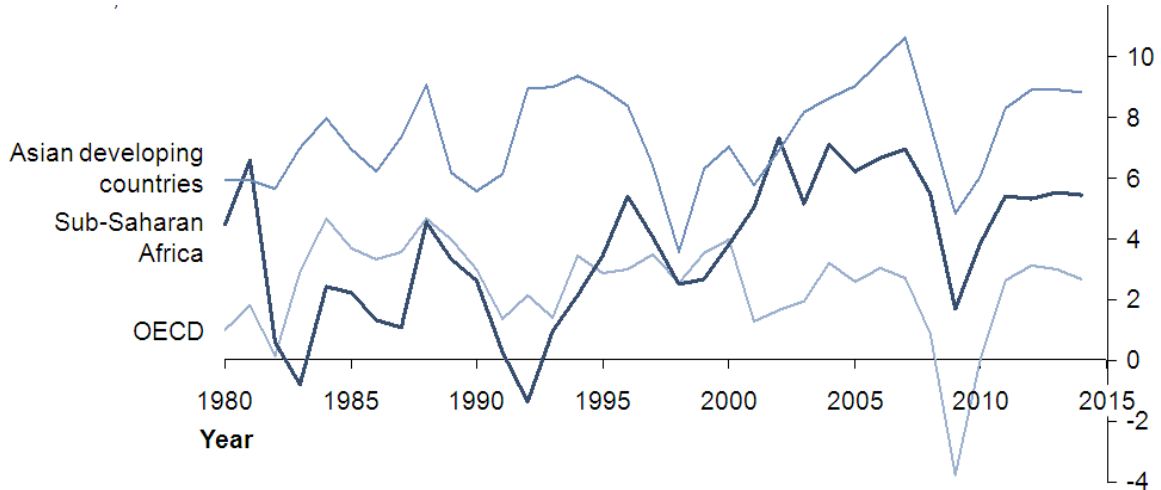
Irrespective of that criticism also has been raised, the overall conclusion is that commercially oriented private sector operations have been an indispensable vehicle for economic growth and poverty reduction. This is most clearly demonstrated by the impressive economic development in South East Asia. Sound private sector investments bring about direct, measurable development effects: jobs and increased income to populations; tax, tariffs and other income to governments. A common denominator in success countries has been the increasing investments in private sector and technology transfer partly through foreign direct investment (FDI) from more advanced economies. Or, more generally, policies favoring openness.

#### **4. Market opportunities and Nordic industry**

As shown in Figures 6 and 7, the world economy has undergone drastic change where growth has been accentuated in emerging and developing markets, while being more constant or lagging behind in industrialized countries. This is particularly pronounced in Asia

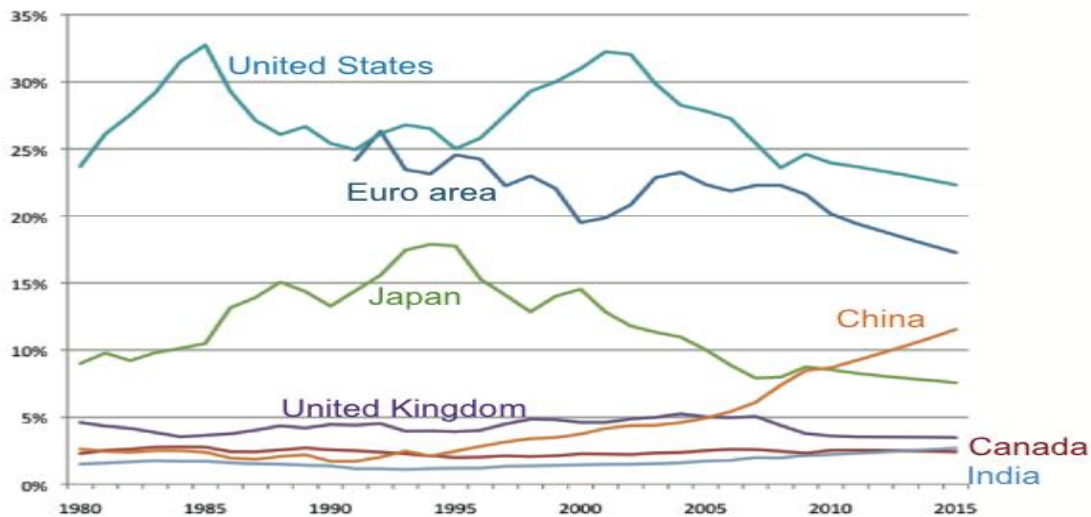
and China, but also Sub-Saharan Africa and India report a positive development while this is less pronounced in Latin America and the Caribbean.

**Figure 6. GDP annual growth in developing and emerging economies and in G7**



Source: Dahlberg 2010

**Figure 7. Shifting global growth patterns**

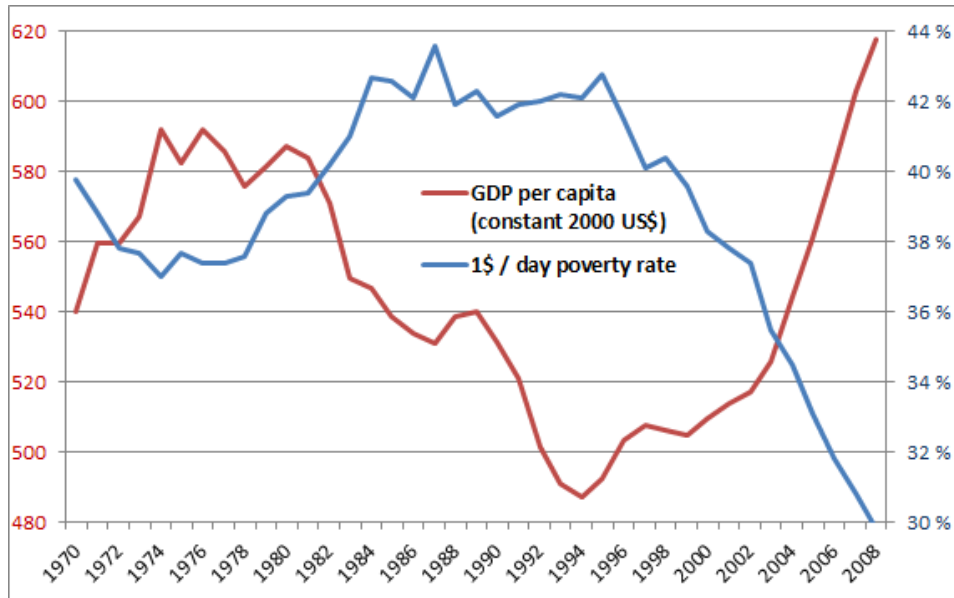


Source: World Development Indicator (2010)

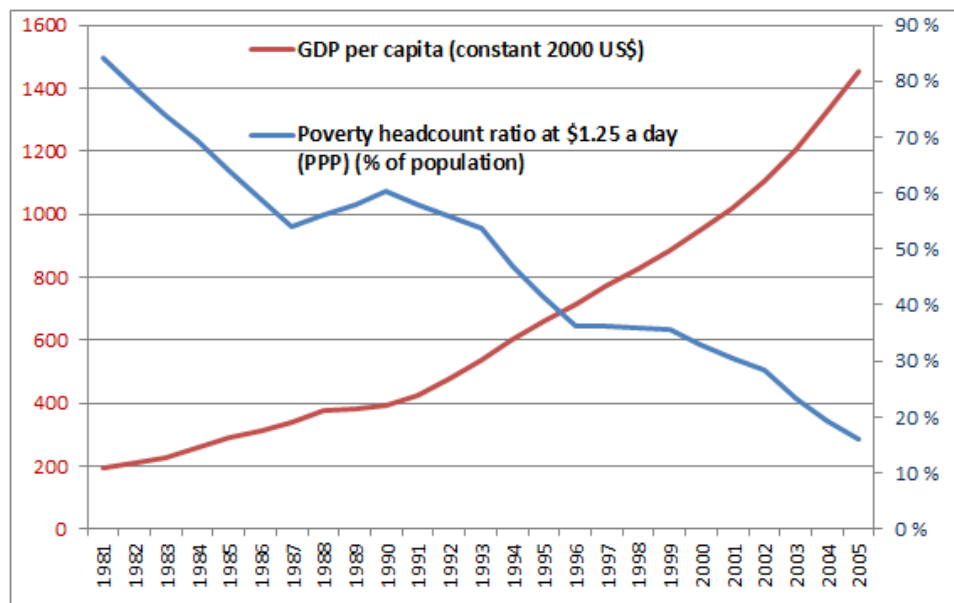
In terms of GDP per capita and poverty reduction measured as the share of population living on less than a dollar a day, progress has been impressive in Sub-Saharan Africa in the last

decade (Figure 8).<sup>15</sup> China started on a similar path much earlier, albeit after several decades of no or modest growth (Figure 9).<sup>16</sup>

**Figure 8. Africa's growth and poverty reduction 1970 to 2010**



**Figure 9. China's growth and poverty reduction 1980 to 2005**



<sup>15</sup> Kuznets (1955) claimed in a famous article that there was an inverted U-shape as regards the relationship between per capita income and income distribution, i.e. as per capita income starts to increase this will be accompanied by increased divergence in income distribution which peters off as income raises further. Empirically the support is weak (Ravallion and Chen 1997).

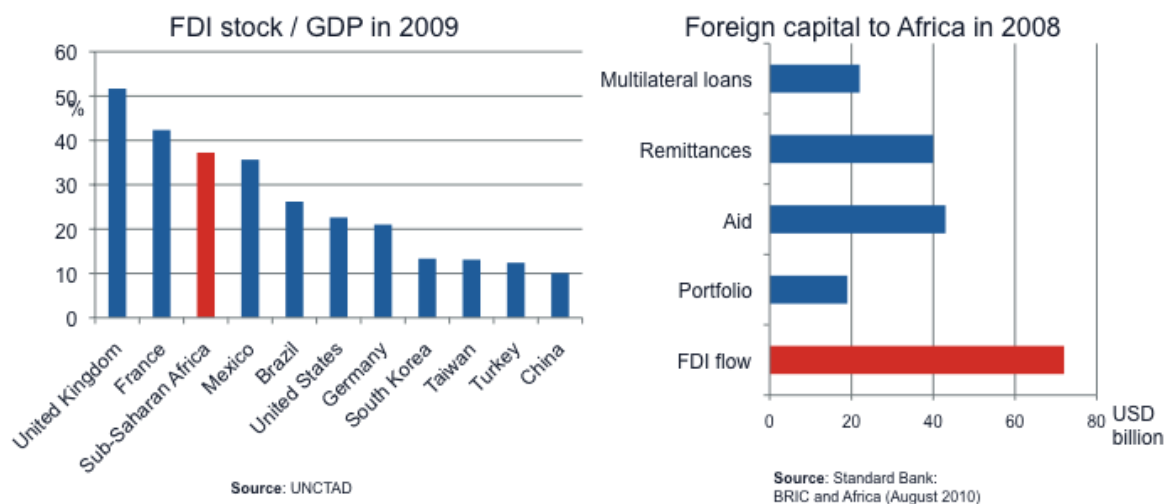
<sup>16</sup> China's own success, and its role as an investor and growth locomotive in developing countries, is undisputed. However, it is too early to give a full account of the effects of China's outward FDI in developing countries. China adhere to a "non-interference" principle also in their foreign policy, the transparency is weak, as is the distribution and trickle-down effects (Lagerkvist and Jonsson 2011).



The radical transformation in growth patterns and development strategies also means that business opportunities have opened up in new markets. In particular, less developed and emerging markets have frequently been overlooked particularly by small and medium sized firms (SMEs) but also by large firms in industrialized economies. Accessing these new markets require firms to adapt their strategies in a way that takes into account country-specific conditions and cultures in those countries (Gatewood and Boko 2009). The stage of development, particularly whether these economies belong to the factor (raw material extraction) driven stage, the efficiency (early industrialization) driven or are approaching the innovation (advanced industrialization) driven stage, would have implication for type of business opportunities and market strategies.<sup>17</sup> Most countries, albeit to varying degrees, embrace all of these stages.

The information gaps are severe. Knowledge about business customs and opportunities are scarce, particularly for SMEs in potential investor countries. At the same time SMEs often need to scale up their activities in order to stay competitive, where internationalization is one strategy. Consequently, opportunities for synergetic effects seem ample. There are also signs of increasing firm activities in developing and emerging economies (Figure 10), however, primarily driven by large firms. Still, there is a widespread lack of knowledge of market opportunities in emerging and developing countries that hinders the exploitation of such opportunities while at the same time deterring growth.

**Figure 10. The importance of FDI**



<sup>17</sup> This is obviously of importance for the motive to engage in a foreign country and the expected outcome of such projects (see Hansen 2010).

### *How to deepen the industrial links with developing economies: Previous experience*

A window of opportunity has opened up that could both spur growth in the developing economies simultaneously as the interactions and exchange with industries in developed economies increases. The DFIs may be an efficient vehicle to bridge information gaps and accelerate that path of PSD led development. Below we present a limited number of success cases from each Nordic country, where it is shown how the DFIs can contribute to intensifying the links between Nordic industries and developing economies. The cases represent different host countries as well as different sectors.<sup>18</sup>

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#### ***Fan Milk – IFU helps producing dairy products and jobs***

*From humble beginnings in the 1960s, every day thousands of people in seven West African countries buy frozen dairy and juice products from the characteristic vendors in blue uniforms that set out every morning from Fan Milk's depots. It was in the 1960s when a Danish businessman came to Ghana and realized that the country held the potential for a sustainable business in dairy products. But it took more than two decades to make it a success after several setbacks due to political, commercial and financial reasons. Today the Danish-owned Fan Milk has developed into one of the leading brands for dairy products in West Africa. It sells affordable frozen dairy and juice products in seven African countries and creates employment for more than 25,000 people.*

*Today Fan Milk is one of the leading brands within dairy products, known and appreciated by most West African consumers. One reason for its success is product development. Each product based on imported milk powder has been developed to meet the taste and need of local consumers. Equally important, the products are packed and sold in units that people in West Africa can afford. In that sense Fan Milk has proved that the base-of-the-pyramid concept is viable as a commercial business model.*

*Another key element in its success is distribution. To reach the many consumers, Fan Milk has developed a unique distribution system, where individual vendors sell the products directly on the street. The vendors are independent agents, who use a bicycle or a push cart with an integrated cool box provided by Fan Milk "Fan Milk has faced many challenges doing business in Africa, but over time we have learned, and today we have a good sustainable business that creates income for the employees, the vendors and other stakeholders," says Jens Jørgen Kollerup, managing director of Fan Milk International.*

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<sup>18</sup> Data is provided by the respective Nordic DFI.

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### **UCL – Finnfund investing in high-quality drugs for Africans**

*Universal Corporation Ltd (UCL) of Kenya produces affordable, high-quality drugs for African countries. UCL is one of the largest drug producers on the continent and has been certified under the European PIC/S scheme.*

*Established by an experienced Finnish-Kenyan, UCL began operating at the turn of the millennium. Its products include generic drugs for treating AIDS, malaria, tuberculosis, parasites and inflammations, among others. More than 100 different pharmaceutical products are made in its production plant near Nairobi.*

*Much of UCL's equipment is second-hand, acquired inexpensively from Europe, where many relatively modern but not fully automated production lines and factories have been closed down as the pharmaceutical industry has consolidated.*

*UCL is now one of the largest and most advanced drug producers in sub-Saharan Africa, and continues to grow rapidly. It now employs more than 300 people directly and has a capacity to produce well above 2.5 billion pills per year. UCL has been approved in inspections conducted by several African authorities as well as aid organizations operating in Europe and America and it is working towards the World Health Organization (WHO) certification that usually is a prerequisite for sales to multilateral aid organizations.*

*After two rounds of financing since 2005, Finnfund is now the main outside investor in the company. At the same time, UCL has become Finnfund's largest equity investment. In addition to helping the company expand, Finnfund has financed UCL's environmental investments and its work towards WHO certification. Finnfund has also participated actively in company's strategic planning and corporate governance.*

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### **Vietstar – Swedfund's investment in environmental technology in Vietnam**

*Vietstar is Vietnam's first facility for waste processing. The investment was made in 2008 and the plant can handle 1 200 tons of waste per day, separating between organic waste, plastics and metals. All organic waste is turned into compost and sold to the agricultural sector.*

*Plastic items are recycled by Vietstar and converted into Low Density Polyethylene (LDPE) granulate, which is sold to plastic producers. LDPE can replace more expensive oil-based inputs that are currently imported. Also metals are recycled and reused.*

*Not only is waste recycled but the overall environment in the Ho Chi Minh regions is considerably improved and the greenhouse emission gases considerably reduced since more than 80 % of the waste previously deposited at rubbish heaps is now recycled. The investment therefore also has positive health effects for local inhabitants.*

*The investment contributes to the diffusion of advance environmental technology, benefiting both cities and the country side. In addition, the investment is expected to yield about 600 jobs, whereof 70 percent of employees lack previous education and almost 50 percent are women.*

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### ***SN Power – Norfund investing in hydropower in emerging markets***

*In 2002, Norfund established the energy company SN Power as a joint venture with the Norwegian company Statkraft – Europe's largest renewable energy company. SN Power is building on Norway's 100 years of hydropower experience. Its strategy has been to engage in profitable investments in the rehabilitation and construction of hydropower plants in low-income countries. The owners have provided technical expertise, expertise in project management for complex developments, and their understanding of financial matters and business in developing countries. SN Power is Norfund's most comprehensive investment, and the company is experiencing strong growth and plays a significant role as an energy supplier in a number of low-income countries.*

*SN Power is now a leading commercial investor and developer of hydropower projects in emerging markets. The company is currently operating 17 power plants in five countries, and is producing electricity equal to the consumption of 10 million people. SN Power projects are reducing the annual CO2 emissions by 1,6 million tons, a figure expected to increase to 10 million tons annually by 2016 based on SN Power's pipeline of new investments – an amount equal to the current total CO2 emissions from all road traffic in Norway. The NOK 2.3 billion capital that Norfund has invested in SN Power has been matched by more than the tenfold amount from other investors – NOK 24 billion, a perfect example of how public capital can scale up investments in renewable energy to meet the energy needs of developing countries.*

*In 2009, SN Power and Norfund established SN Power AfriCA, a subsidiary company to focus on investments in Africa and Central America. The Norwegian power companies BKK and TrønderEnergi bought into the company in 2009, and own 19 and 46 per cent respectively. The company is expected to make investments that will produce significant development effects and develop the major potential for hydropower and wind power in the region.*

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Altogether these cases illustrate how private market entry in developing countries by Nordic firms representing different industries may promote a number of beneficial effects that extends beyond effects related to the operations of the firms.

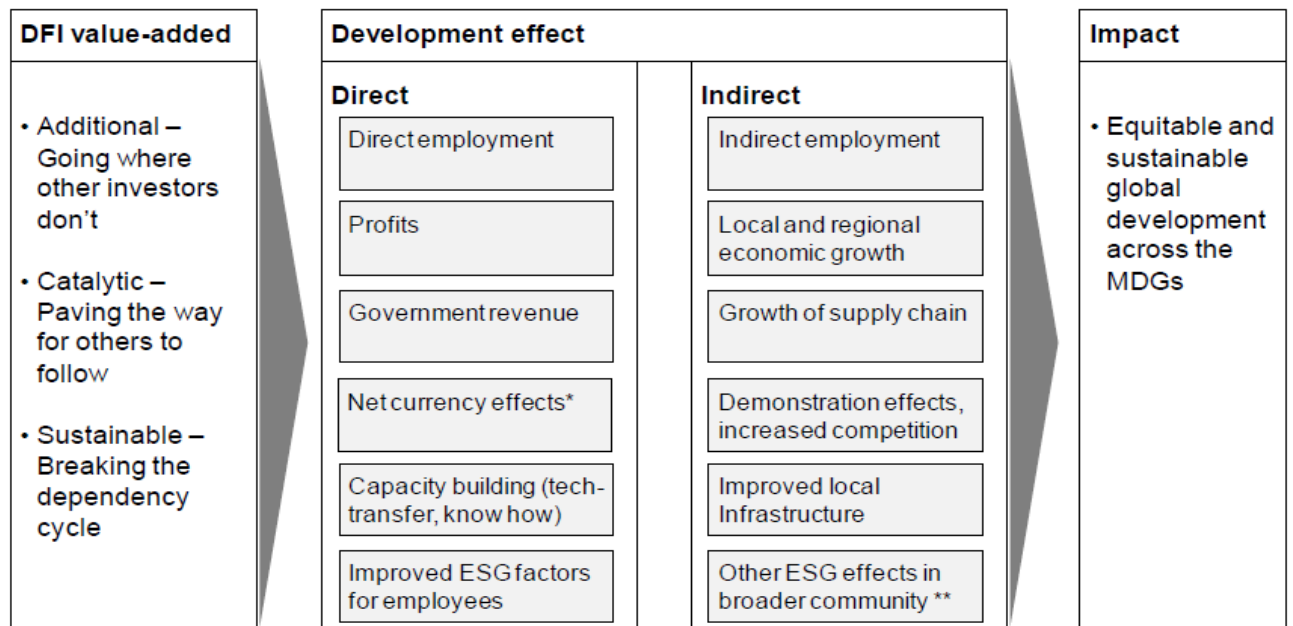
## **5. How can the Nordic DFIs contribute to economic development?**

The Nordic DFIs are part of a much larger and interconnected system of similar organization. In Europe there are 15 DFI organizations, interconnected through the Association of European Development Finance Institutions (EDFI). The most important multilateral organization currently is IFC which is a sister organization of World Bank. In 2010 IFC disbursed \$ 5.8 billion (\$ 1.6 billion in equity plus \$ 4.2 billion in loans). The total outstanding portfolio encompassed \$ 25.4 billion, distributed on \$ 5.4 billion in equity and 20.1 billion in loans. Other international organizations are The European Bank for Reconstruction and Development (EBRD) that provide loan and equity capital to projects in Eastern Europe and the former USSR. Likewise, the Inter-American Development Bank (IDB) also provides loans and equity investments to private sector projects. Also other multilateral institutions also have private sector programs.

DFIs are expected to contribute to economic development through several channels. The most important are shown in Figure 11. Additionality emanates from investments in regions, segments and sectors that are not considered by other investors. The catalytic role played by DFIs occurs as they team up with private investors, enabling firms to trade with and invest in countries they would otherwise forego. Finally, DFIs are expected to contribute in overthrowing the aid-dependence cycle that traps some developing economies lacking the ability to develop a sustainable market driven economy. Hence, DFIs could thereby add value by going into underserved projects and settings (agriculture, post-conflict areas, etc), undercapitalized projects (financial sectors, energy and infrastructure) and mobilize other investors (SMEs, share knowledge, sets standards).

Rated by the receiving economies, survey data collected by the IFC shows that the contributions of the DFIs are viewed as substantial, for instance in the financial sectors (Figure 12).

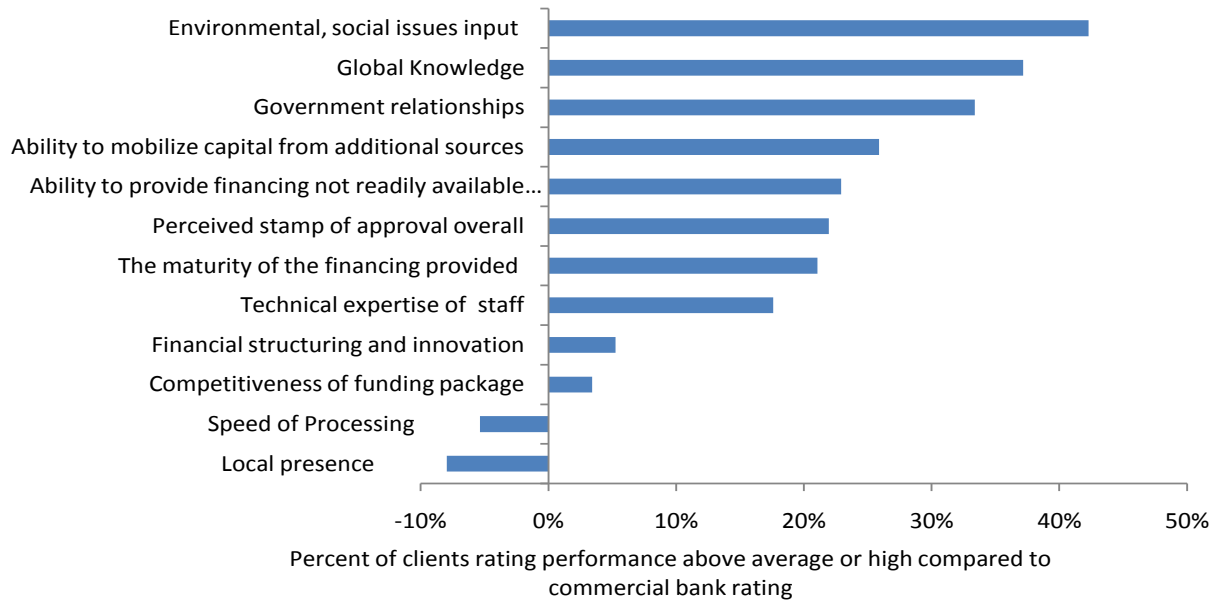
**Figure 11. How DFIs contribute to economic development**



\* Net currency effects estimate the total contributions to the national balance of payments (exports minus imports). This is a useful measure because many developing countries have a balance of payments deficit, so contributing to reserves gives stability to the macroeconomic environment and supports the central bank

\*\* ESG denotes environmental, social and governance factors

Source: Swedfund. (2008): "New thinking, new markets - Sustainability report 2008"; Norfund. (2008): "Creates value, combats poverty – Contribution to development 2008"; DEG. (2008): "Corporate policy rating ("GPR")"; CDC. (2008): "Development Report 2008:" and Dalberg analysis

**Figure 12. Performance of DFIs versus commercial banks for private sector clients**

Source: IFC Surveys

Also other measures are used to evaluate the contributions and impact related to DFI projects. According to the EDFI an average of 5 billion euro in new private sector projects was generated per annum over the years 2006 to 2008.<sup>19</sup> Furthermore, it is claimed that the European DFIs had contributed to about 500,000 total direct jobs, 1.3 million indirect jobs procured through value chains and sub-borrowers, 1.7 billion Euros in annual government revenues and 4.7 billion Euros in annual net currency effects. Based on IFC assessments, each DFI dollar can support as much as 12 dollars of total project investment and tax revenue effects related to DFI project are expected to multiply by a factor three. Finally, these investments generate payback to the DFIs that can be reinvested, in addition to a number of other positive host country effects.<sup>20</sup>

<sup>19</sup> Dalberg (2010).

<sup>20</sup> See IFC 2010 Annual Report (p 92). Measurements problems do exist but an overwhelming share of the assessments claim quite considerable effects of DFI activities. In addition, they have demonstrated more of stability as investors compared to other more fluid capital, particularly during the crisis.

Even though levels and magnitudes of these positive effects can be discussed, the evidence points in the directions of substantial growth contributions of the DFIs in receiving countries. Notwithstanding these positive effects, criticism has been raised with regard to the criteria used in evaluating the effects of DFIs'. It is argued that they are too complex and too difficult to relate to the activities by DFIs. Another strand of criticism claims that too much weight is put on company related criteria and too little on the effects on development. This makes it harder to assess the degree to which policy objectives are being reached. Therefore it has been suggested that current criteria should be extended to embrace measures like accountability, on- and offshore activities, inclusiveness and globalization (Bracking and Ganho 2011).

#### *Home and host country impacts of DFIs*

The most detailed analysis of the economic effects of a Nordic DFIs have been conducted in Denmark by Hansen et al (2006) and Hansen (2010).<sup>21</sup> The overall assessment is quite positive, stating that IFU has had considerable direct (their own investments), indirect (involving local partners) and spillover effects (enhancing competition, knowledge contributions, etc.). Each IFU job in host countries is shown to generate another two job opportunities, which is likely to be the net effect considering that about 70 percent are greenfield investments while the remaining are takeovers, i.e. a change in ownership (which however also can generate a number of positive spillover effects). Overall the crowding out effects seems negligible. In terms of investment effects, Hansen (2010) comes up with a similar number as many other studies regarding the additional investment impact, i.e. one IFU invested Danish Krona propels another three Kronas in investment. At the same time it is stressed that large firms do impact development more significantly in host countries as compared to SMEs, hence it is important to include also large firms.

Finally, also home country effects seem to be overall positive and thus DFIs enable activities that complements rather than substitutes home country operations. The results corroborate previous studies. A particular concern has been whether DFIs contribute in "exporting" domestic jobs. There is however no indications that this would be the case. Rather there seem to be overall positive effects in home countries since expanding business activities in

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<sup>21</sup> See also the evaluation of Norad, Devfin (2010).

developing countries leads to expansion also of home country units. The situation is different when it comes to investments in other developed economies, which are shown to have more of a substitutionary effect with regard to home market activities.<sup>22</sup>

What difference does the Nordic DFIs make? As indicated above, these funds can no doubt make an important contribution to private sector development when adequately funded and efficiently organized. Primarily their impact occurs through what could be named a double multiplier effects: first, the revenue generated through successful investments is channeled into new and additional investments, often targeted to neglected countries and sectors; second, by involving additional investors that enters new and unexploited markets.

The more business-friendly and supportive the political environment is in the host country, the more immediate the impact is likely to be. Even in a difficult environment, however, DFIs can have an impact; for example, they can exert pressure on governments to reform. In the most favorable environments—all else being equal—a positive impact may be evident in a few years; in less favorable environments, or where there are other difficulties, a positive performance (including returns on investments) may take more than a decade.

#### *Nordic DFIs: Some basic facts*

What are then the mandates of the Nordic DFIs and where do they operate? An overview of their activities, organizational form as well as their investment and the investments distribution on regions and sectors is described in the boxes below. Moreover, the development effects as estimated by the DFIs with regard to employment and taxes are presented, together with some additional facts. As can be seen, there are obvious differences in several dimensions between the Nordic DFIs.<sup>23</sup>

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<sup>22</sup> See Braunerhjelm et al (2000), Hansen et al (2006), Ekholm (2009) and Hansen (2010).

<sup>23</sup> Data is provided by the respective Nordic DFI, all figures by 31 December 2010



**IFU**

**Mandate:** For the purpose of promoting economic activity in developing countries, IFU has been created to promote investments in these countries in collaboration with Danish trade and industry.

**Strategy:** To advise and co-invest with Danish companies establishing business in developing countries and emerging markets.

**Operation:** Invest on commercial terms always with a Danish partner and normally with a 20-35% stake, never in majority.

**Organizational form:** IFU is an independent, self-governing and revolving fund associated with the Ministry of Foreign Affairs.

**Employees:** 71                      **Equity:** DKK 2304 million

**Investment by sector:** Manufacturing: 60% Trade and transport: 13% Finance and insurance: 8% Agriculture 7%.

**Investment by region:** Asia: 46% Africa 33% Latin America 15% Europe 4% Global 2%

**Share and numbers of partners:** Always invests with Danish partner. More than 700 projects involving more than 400 different Danish partners.

**Development effects:** Approx. 150.000 direct employees in IFU's project companies. Education and training of employees in approx. 90% of IFU project companies. All project companies must comply with basic CSR requirements according to IFU's CSR policy.

## Finnfund

**Mandate:** Finnfund promotes economic and social development in developing countries by financing responsible and profitable private projects.

**Strategy:** While funding is not tied to Finnish exports, Finnfund works mostly in sectors where the experience and competence of the Finnish business community can be harnessed to serve developing markets. Forestry, renewable energy, telecommunications and environmental technologies are priority sectors, along with manufacturing projects, many of which are linked to the above sectors. Through funds and financial institutions Finnfund also finances local small companies, mostly in the poorest countries.

**Operation:** Invests on commercial terms, always a minority investor, most investments are in the range of EUR 1-10 million.

**Organizational form:** Limited liability established and operated under special legislation (the Finnfund Act). Apart from a minority stake held by the Confederation of Finnish Industries EK, Finnfund is state-owned and operates under the auspices of the Ministry for Foreign Affairs.

**Employees:** 46

**Equity:** EUR 162 million

**Investments:** Committed investments: EUR 470 million in 142 companies. Average investment EUR 3.3 million

**Investment by sector:** 7.7% forestry, 18.7% resource based industries, 7.4% manufacturing, 8.5% energy and environment, 3% hotels, 2.1% health services, 1.7% telecommunications, 7% other infrastructure, 31.9% funds, 12.3% other

**Investment by instrument:** 19.3% equity, 27.3% private equity funds, 53.3% loans

**Investment by region:** 34.6% Africa, 16.6% Latin America, 23.2% Asia, 25.6% others

**Investment approvals 2010 relative to overall aid budget:** 12% (Committed investments in 2010 EUR 87 million / Finland's total aid budget of EUR 751 million)

**Share and number of partners:** Finnfund invests mainly with Finnish companies and their local partners, such as long-term customers, suppliers, subcontractors and companies that license technology. In the poorest countries Finnfund generally co-invests with other development financiers, both in projects that use Finnish technology and in other projects that generate significant environmental or social benefits.

**Share in LDC:** 16.9% Share in SSA 34.7%

**Development effects:** Most of Finnfund's investments have created more productive and better-paying jobs by transferring modern technology, and many have improved the access of hundreds of thousands of people to basic goods and services such as safe and effective drugs, inexpensive telecommunication services and reliable clean energy. Some investments have created new markets for what thousands of small farmers produce while others have brought cleaner air and water to millions by modernizing outdated industries.

## Norfund

**Mandate:** To create sustainable commercial activities in developing countries by establishing and developing viable, profitable businesses which would not otherwise have been initiated due to the high risk involved.

**Strategy:** Investments concentrated on a limited number of countries with emphasis on Sub-Saharan Africa and LDCs. Sector focus on renewable energy, agriculture and financial institutions.

**Operation:** Invests on commercial terms, always with partner(s) and normally with a 20-35% stake, never in majority. Not tied to national business of companies

**Organizational form:** Special purpose company with limited liability established and operated under special legislation (the Norfund Act ) and fully owned by the Norwegian Government through the Ministry of Foreign Affairs.

**Employees:** 45                      **Equity:** 6747 NOK million

**Investments:** Committed investments: NOK 5844 million in 85 companies. Average investment NOK 39 million.

**Investment by sector:** 46% renewable energy, 25% SME funds, 20% financial institutions, 9% industrial partnerships

**Investment by instrument:** 54% equity, 31% private equity funds, 15% loans

**Investment by region:** 37% Africa, 34% Latin America, 27% Asia, 1% others

**Investments 2010 in percentage of overall aid budget:** 3 percent (Committed investments in 2010 NOK 844 million/Norway's total aid budget of NOK 27.7 billion)

**Share and number of partners:** Always invests with partners

**Share in LDC:** 24% **Share in SSA** 37%

**Development effects:** 165 000 employees in Norfunds investment portfolio, 53 000 women (32 percent). The companies paid NOK 2.7 billion in local taxes in 2010 (not weighted according to Norfund's ownership share and it excludes income taxes paid by employees. Norfund's weighted share of corporate tax would be NOK 36 million.)

**Swedfund**

**Mandate:** To promote sustainable economic development in poor countries

**Strategy:** Investment in LDC

**Operation:** Commercial terms, always invest with partner(s) and usually a 30% stake

**Organizational form:** Swedish Aktiebolag (AB) wholly owned by the Swedish government through the Swedish Ministry for Foreign Affairs

**Employees:** 38                      **Equity:** SEK 2711 million

**Investments by department:** Financial institutions 13%, infrastructure 45%, other 42%.

**Investments by instrument:** Private equity 41%, private equity funds 23%, loans 36%.

**Investments by region:** Africa 49%, Latin America 2%, Asia 34%, Eastern Europe 15%.

**Investments 2010 in percentage of overall aid budget:** 1.1 percent (Committed investments in 2010 SEK 369.4 million/total aid budget of 33 billion).

**Share and number of partners:** Always invest with partners

**Share in LDC:** 55%   **Share in SSA:** 49%

**Development effects:** The companies paid SEK 219 million in local taxes in 2010.

## **6. Recommendations for growth promoting policies and how to intensify cooperation between Nordic firms and developing countries**

The objective of this report has been to evaluate how DFIs' can contribute to higher growth and reduce poverty in less developed and emerging economies. Based on the different paths taken by countries in for instance Latin America and Asia, a research overview, and previous accomplishment of DFIs, a number of policy conclusions are presented below. These are categorized on the level of implementation and on receivers, i.e. policymakers and the business sector.

The main trust of the report can be summarized as follows:

- *Private sector development plays a key role to alleviate poverty and increase the standards of living in a large number of countries facing huge development challenges.*
- *Private sector development is contingent upon an appropriate institutional framework and rule by law provided by the government that supports ownership, competition and openness.*
- *Economic development and sustainable economic growth thus require both efficient public and private sectors in order to encounter the development challenges.*
- *Private sector development can play a particularly important role to bridge the gaps in key sectors such as finance, management and knowledge transfers.*
- *In conjunction with the governments, private sector agents can reduce constraints in strategically and system important infrastructure sectors related to knowledge, energy and transports.*
- *Based on the most commonly used criteria in the evaluations of DFIs, they seem to have propelled growth and contributed to private sector development by reducing risk and uncertainty, initiating partnerships with local and home country based firms, providing financial means and propelling knowledge spillovers. Still, there seems to be room to modify and extend evaluation criteria in order to better grasp the DFIs' success and impact in receiving countries.*
- *Finally, the market opportunities for firms in donor and receiving countries of the DFIs' activities are considerable, but still largely neglected by the business sectors of the Nordic countries. DFIs can propel development by bridging information gaps and by mitigating risks through co-investments, guarantee instruments, funding early stages and by complementing traditional aid policy.*

We will start with a brief account of the responsibilities of the international community and host countries; thereafter we proceed with recommendations to policymakers covering both the macro- and micro-levels, albeit focus is on the latter level. Finally, we address the business society in the Nordic countries. Thus, in order to obtain full leverage of policies at all levels – international and national – as well as the recognition of business opportunities

and the willingness/strategies of Nordic industry to engage in business with countries, must be considered.

### **Advice to policymakers**

#### *The international level*

We have discussed the importance for developing countries to pursue policies dedicated towards openness and transparency. A similar argument should be made for the developed countries: it is their obligation to make sure that markets are open for trade and foreign ownership, including the developing countries. As is obvious from the last wave of globalization, which elevated millions of people out of poverty, it is of utmost importance that developing countries have market access and are not excluded from investing in the Nordic countries. Hence, at the national level the Nordic governments must work towards reinforcing openness also in periods of stagnating growth and downturns in the business cycle. Similarly, at the international level the Nordic countries should forcefully argue for a continuation of trade liberalization and deregulation, e.g. encouraging a reopening of the Doha negotiations.

#### *The macro level*

We will focus primarily on the micro-level, but would first like to make a few remarks regarding the macro-level (and to some extent the meso-level). A well-functioning market-based economy rests on a macroeconomic setting that guarantees stability, openness and transparency. Moreover, aid fungibility, i.e. that de jure decisions corresponds with de facto interventions, builds on accountability and reliable information regarding measures undertaken, and the expected outcomes of those activities across different areas.

A first priority is to provide support for an institutional setup that is conducive to growth. This implies thrust-worthy rule of law, private ownership, credible sanctions if rules are violated, the abolition of corruption and transparent decision structures.

A second priority has to do with improving the quality of economically system important infrastructure sectors. Those relate to energy, transport, knowledge and health, are often dependent on support of technical and legal character, in addition to plain resources.

Third, promoting competition and setting up bilateral investment and trade treaties with developing countries would be a second best solution if the Doha negotiations continue to be stalled.

Basically the macroeconomic measures imply fostering an enabling environment and well-functioning domestic markets in receiving countries, which can be further strengthened through well balanced micro-economic PSD-policies. Where enabling environments are in place, DFI activities are more likely to be associated with more sizeable benefits.

#### *The micro-level*

The bottlenecks of development often adhere to malfunctioning private markets and weak financial sectors. As shown above, DFIs have a capability to positively contribute to the development of both the private sector and the financial private sector. In addition, there seems to be a complementary role between traditional aid on the one hand and DFIs/PSD on the other. The latter focuses on providing relevant business knowledge, put emphasis on microeconomic dynamics and promote leverage of private investments in receiving and donor countries.

One should also acknowledge the risks associated with a stronger orientation towards DFIs and PSD. Previous international studies on the effectiveness of aid stress that a micro-focus disregarding the overall aid and developing context may fail. Too much risk aversion may crowd out other private companies and deter potential additionality. Consequently, the different agencies responsible for PSD need to be efficiently integrated into the overall objectives of a country's aid structure. However, that particular aspect falls beyond the scope of the current study and there is no indication of a problem along those lines in the Nordic countries.

Given that DFIs have the potential to contribute to reduced poverty and to reinforce growth prospects in receiving countries, they seem well equipped to also serve as door openers for Nordic industries without harming other economic activities in neither donor or receiving countries. If there is a policy objective to make emerging markets more accessible for Nordic firms, then obviously that task should be pursued by the governmental agency endowed

with the most appropriate skills to accomplish that goal.<sup>24</sup> Furthermore, if tasks and means have been allotted to aid agencies (or governmental agencies in general) in a way based on traditions or state of the art at the time when these policies were installed, changing conditions may call for an analysis and overhaul of the present architecture and distribution of tasks between such agencies.

Hence, if it is the case that policy objectives such as export promotion, providing information that facilitates market access, enhance goodwill, etc., can be obtained within already existing agencies at comparatively low costs, such as the DFIs already engaged in operations in developing countries, then governments should take advantage of such possibilities (Holmquist 2004). This is basically an efficient way to mitigate market failures and implies that a budget reallocation between agencies may be motivated if this would serve to increase the overall efficiency of aid policies.

This should not be confused with the tying of aid, which is a different matter. Yet, some voices have been raised in favor of increasing tied aid in order to involve more of Nordic industry and facilitate market access, but also to make sure that aid transfers do not end up in bank accounts of present rulers, and similar abuses. Tied aid is however connected with considerable cost in receiving countries and may be of modest value for donor countries.<sup>25</sup> Therefore remaining elements of tied aid should be phased out.

Our main recommendations related to the mandate and responsibilities of DFIs are as follows:

- DFIs should carry more of responsibilities for business and private sector development and market oriented activities whereas conventional aid, institutional support and public sector development (health, education, etc.) should be undertaken by traditional aid organizations.
- DFI activities must be fully transparent structures with regard to their domicile, tax implications, environmental issues, local “ownership” of projects and other host

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<sup>24</sup> Note that some studies report strong positive effects of export promotion: one dollar in export promotion may render between six to 12 dollars in additional exports (Kaiser and Liu 2000, Holmquist 2004).

<sup>25</sup> Krueger (1998) claims that tied aid reduce its value with 25-50 percent.



country effects. The Nordic countries do however seem to fare well in an international context.

This is basically a specialization and an efficiency argument. One organization is unlikely to provide all services in-house while maintaining the highest professional level.

The “supply” of different interventions and instruments to combat poverty and induce self-sustaining growth should be interlinked and communicated between actors such that coordination failures can be avoided. This would serve to promote “smarter” and more cost efficient PSD-strategies. Increased cooperation and co-investment may also be a way to better exploit the “Nordic brand”, facilitate market access for business and make sure that tying becomes less likely. For instance, support to enterprises in receiving countries such as training, transfer of technology and competence building should at least partly be the responsibility of traditional aid organization, but undertaken in close cooperation with DFIs. Public-private-partnerships could be used more frequently.

SMEs are often the backbone of private sectors in developing countries, but frequently face the most severe obstacles in terms of finance, investments and growth.<sup>26</sup> Smaller companies have been shown to be the most important job generators and have the potential to become instrumental in the struggle against poverty. Therefore, while remaining open to cooperation with large firms, it is important to ensure that small and medium-sized firms become an integrated part of the DFIs activities.<sup>27</sup>

Adaption to local prerequisites is essential. Policies must originate in a clear analysis of the strengths, weaknesses and dynamics of local private sectors. A “one size fits all” strategy is less likely to succeed. This is also an argument why several “competing” DFIs serve a purpose, having different experiences and expertise which is associated with each country’s comparative advantage. To further enhance the positive impact of the Nordic DFIs they should strive to closer interaction in order to exploit their complementary skills and exploit economies of scale.

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<sup>26</sup> Finance for All, World Bank, 2007

<sup>27</sup> Some of the DFIs in other countries have targeted funds to that allow them to invest in SMEs, and there is also a G20 initiative to expand the availability of support to the SME sector.

- DFIs and other aid policy initiatives should be coordinated in order to increase efficiency and to maximize leverage of aid interventions. In addition, more cooperation between Nordic DFIs, the DFIs and traditional aid organizations and the DFIs and private firms, should be encouraged.
- Public-private-partnerships (PPPs) seem to be underutilized. Such arrangements may constitute a good way to finance large-scale infrastructure projects (communication, education, energy, health and transports).
- Smaller firms in receiver countries should be an integrated part of DFIs' activities. Measures should be adapted to local prerequisites.

The most important factor behind growth in developed countries is innovation and it is also likely to be strategically important in developing countries. In addition, as shown by Gatewood and Boko (2009), there are a number of innovations in less developed countries that has become useful also in developed countries. The DFIs could be a tool to promote innovations in developing countries through new instruments such as challenge funds, output-bound funds and innovation funds. Result-based funding, or "output-based" instruments, have gained in popularity and may be an appropriate tool to enhance the effectiveness of public funding. The idea is basically that the disbursement of public funding should be linked to the achievement of pre-agreed results.

Functioning financial markets is generally crucial for economies to operate efficiently, and in particularly so in more risky endeavors. Projects often taken longer time to be executed than anticipated, unexpected delays are quite normal in developing countries. All this requires a financial "staying power" which may be the difference between success and failure. In addition, there may also be other risks that have to be considered and possibly alleviated. Within the area of export financing there are investment guarantee products covering the political risk. These guarantees may be used also in projects undertaken in developing countries however there is a condition regarding sufficient involvement of domestic export. We believe that a government political risk insurance scheme should be considered in each of the Nordic countries. This would be similar to the MIGA insurance scheme of the World Bank Group.

- DFIs should consider working with a broader set of instruments aiming at stimulating SME development, local innovation capacity and problem solving. Links to innovation systems actors in donor countries, including other aid institutions, seem to constitute natural cooperation partners in such strategies.
- An increased focus on developing local financial markets and reducing financial risk should be prioritized. A MIGA type of insurance schedule should be considered.

### **Advice to the Nordic business sector**

Developing economies have in recent years received increasing attention by the business sector in developed countries. Inward foreign direct investments to developing economies has been increasing substantially since the beginning of the 1990s, first to China, East Asia and Latin America, then later also to Sub-Saharan Africa (SSA). Note that while there was a severe decrease in FDI flows to the former regions during the global crises in 2008-2010, FDI continued to increase in SSA. In addition, SSA seems to be on the rise, export is becoming more sophisticated and the economies are to a larger extent driven by dynamic and innovative processes.<sup>28</sup>

In a developing country wages per hour may be very low compared to wages in more developed economies. However, wages (or production costs in general) per hour are not the important measure, rather one has to look at wages per unit of output. There may be important cultural differences to overcome. In many developing countries the concept of regular work and the necessary discipline in such a regime may be seen as unusual and alien. Still, substantial progress has been made, particularly during the last decade.

An obvious strategy how to increase cooperation and business links between industrialized and developing economies is to embark from the strengths of the respective Nordic countries' industries. As an example, there is considerable expertise and know how in the hydro electric energy field in the Nordic area. This competence should be used extensively in other parts of the world to help balance the energy needs. Using this as an example it is obvious that in order to make successful investments in the hydro electric power area a solid base of technological skill is required. This includes the experience in establishing and

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<sup>28</sup> See for instance Financial Times 19 May (2011) or African Development Bank (2010).

managing such investments in foreign countries. A depth in terms of managerial skills will be required and also solid financial resources.

A task that would fall well within the realm of the DFIs expertise is to make sure that the private sector in their home countries are being well informed and updated on the development in receiver countries. In that respect it would be natural to seek cooperation between the DFIs and employers or branch organizations in the Nordic countries. The already extensive cooperation between European DFIs would facilitate such task.

In order to facilitate such a development the limitations on some DFIs when it comes to financing projects initiated in a different country from their own, should if possible be abolished. The objective should be economic development, not home country export. With their close ties to the industry of their home countries most of the investment financed will irrespective of this originate in the home country.

Investments made by private companies are made on the basis of competitive advantage otherwise the products will not be competitive in the market place. To assess such competitive advantage, including the risks involved, is at the heart of business activity. To give concrete advice to business entities is far beyond the scope of this analysis (and our competencies). Yet, a refocusing at emerging growth markets and Base of the Pyramid countries can be expected as an outcome of globalization. A closer interaction between businesses in developed and developing markets will not only alleviate poverty and improve living conditions, but is also likely to expand markets, generate more of innovation of mutual benefit and contribute to an efficient combating of the Grand Challenges. "Fortune favors the prepared mind" as Louis Pasteur once put it and the DFIs can play an instrumental role in enhancing future prospects for prosperity in receiving as well as donor countries.

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**List of abbreviations**

DFI Development Finance Institutions

EBRD European Bank for Reconstruction and Development

EDFI European Development Finance Institution

FDI Foreign Direct Investment

FINNFUND Finnish Fund for Industrial Cooperation

FMO Entrepreneurial Development Bank of the Netherlands

GIEK Norwegian institute for export guarantees

IFC International Finance Corporation

IFU Danish Industrialization Fund for Developing Countries

IDB Inter-American Development Bank

MFI Multilateral Finance Institutions

MIGA Multilateral Investment Guarantee Agency

NORFUND Norwegian Investment Fund for Developing Countries

PPP Private Public Partnership

PSD Private Sector Development

PSFD Private Sector Financial Development

SSA Sub-Saharan Africa

This is a report from the Nordic Development Finance Institutions

