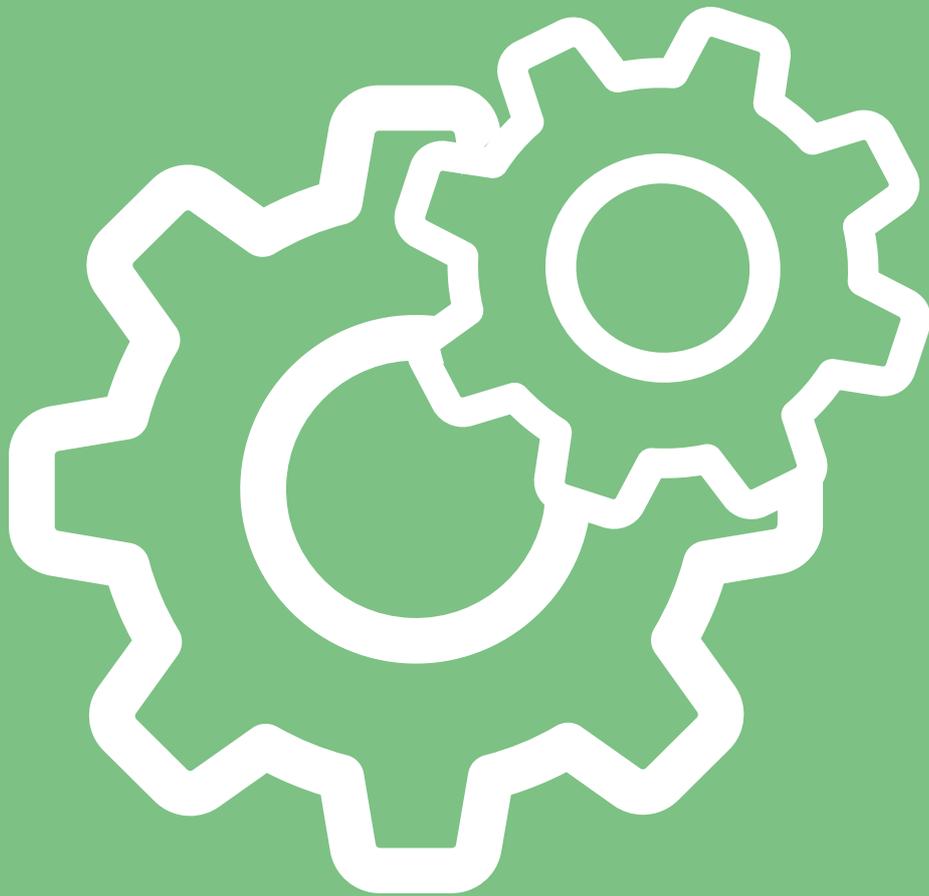

INTRODUCTION

Why a focus on blended
finance in LDCs?



WHY A FOCUS ON BLENDED FINANCE IN THE LEAST DEVELOPED COUNTRIES?

The world's 47 least developed countries (LDCs) face a substantial challenge to mobilize the resources they need to achieve the Sustainable Development Goals (SDGs). While a comprehensive estimate is not available, various data points confirm the extent of the financing gap for achieving the SDGs in LDCs. For instance, the cost to achieve universal access to electricity in LDCs alone is estimated at \$20–30 billion per year.² The overall infrastructure funding gap, including the water, communication³ and transportation sectors, is most likely a multiple of that figure. It is estimated that micro, small and medium enterprises (MSMEs) need hundreds of billions of dollars to grow.⁴

LDCs are a diverse group of countries, with different levels of growth, vulnerability, demographics, geography, and size of the economy.⁵ Some are on a fast track to middle-income country (MIC) status, and others are affected by crises. LDCs are home to 1 billion people, one third of whom live on less than \$1.90 per day.⁶ Despite many LDCs recording impressive improvements in human development, long-term growth projections point to 35 percent of the population in LDCs remaining in extreme poverty by 2030.⁷ Gross domestic product (GDP) growth in LDCs, estimated to reach 5.4 percent in 2018⁸, is higher than projected global growth,⁹ but still below the 7 percent annual rate called for by SDG 8. Individual country performances vary: 5 LDCs achieved the 7 percent target in 2017, down from 14 in 2012; at the same time, 9 of the LDCs for which data are available have

experienced gradual deteriorations in GDP per capita.¹⁰ Life expectancy, years of schooling and percentage of the population living in urban areas are all lower in LDCs than in developing countries as a whole. Just over half (54 percent) of people without access to electricity globally live in LDCs.¹¹



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² United Nations Conference on Trade and Development (2017a). 'The Least Developed Countries Report 2017—Transformational Energy Access'. Geneva: UNCTAD. http://unctad.org/en/PublicationChapters/ldcr2017_ch5_en.pdf.

³ For instance, in 2016, the proportion of the population covered by a 3G mobile network stood at 61 percent in LDCs, compared to 84 percent globally. (United Nations (2018c). 'The Sustainable Development Goals Report 2018'. New York: United Nations. <https://unstats.un.org/sdgs/files/report/2018/TheSustainableDevelopmentGoalsReport2018.pdf>).

⁴ Calculations performed by UNCDF for 39 of the 47 LDCs for which data are available, based on the SME Finance Forum's MSME Finance Gap Database (2017). SME Finance Forum, MSME Finance Gap Database. <http://smefinanceforum.org/data-sites/msme-finance-gap>. (Accessed July 2018.)

⁵ There are 33 LDCs in Africa, 13 in Asia and the Pacific, and 1 in Latin America. Of the 47 LDCs, 17 are also a Landlocked Developing Country, and 9 are also a Small Island Developing State. For more information, see <http://unohrls.org/about-ldcs/>.

⁶ United Nations (2018a). 'Report of the Secretary General. Implementation of the Programme of Action for the Least Developed Countries for the Decade 2011–2020, 27 July 2017 to 26 July 2018'. A/73/80. New York: United Nations. <http://undocs.org/en/A/73/80>.

⁷ United Nations (2018c). 'World Economic Situation and Prospects 2018, Update as of mid-2018'. New York: United Nations. https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/WESP_2018_Mid-year_Update.pdf.

⁸ United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018'. Geneva: UNCTAD. https://unctad.org/en/PublicationsLibrary/aldc2018d1_en.pdf.

⁹ International Monetary Fund (2018). 'World Economic Outlook Update, July 2018'. Washington, DC: IMF. <https://www.imf.org/en/Publications/WEO/Issues/2018/07/02/world-economic-outlook-update-july-2018>.

¹⁰ The five LDCs meeting the 7 percent GDP growth target in 2017 were: Bangladesh, Djibouti, Ethiopia, Myanmar and Nepal. Seven LDCs posted real GDP growth in excess of 6 percent: Burkina Faso, Cambodia, Guinea, Lao People's Democratic Republic, Rwanda, Senegal and Sierra Leone. (United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018').

¹¹ United Nations Conference on Trade and Development (2017a). 'The Least Developed Countries Report 2017—Transformational Energy Access'.

TABLE 1. Key socio-economic data for LDCs vs. all developing countries

As LDCs and their development partners explore all potential sources of finance to achieve the SDGs, there is growing interest in the role of blended finance to complement existing sources that, on their own, are not sufficient to bridge the financing gap.

First, many LDC governments have limited fiscal space and a heightened reliance on external sources of funding. Tax revenues are lowest in LDCs as a whole; few manage levels above 15 percent of GDP (compared with the Organisation for Economic Co-operation and Development (OECD) average of 34.4 percent in 2014), as they typically have lower levels of tax collection and a narrower tax base.¹² Approximately one third of LDC sovereigns are at high risk of debt distress or already in that situation.¹³ Debt service as a proportion of exports of goods

and services increased from a low of 3.5 percent in 2011 to 8.6 percent in 2016.¹⁴ The LDCs' share of world merchandise exports decreased from 1.1 percent to 0.9 percent between 2013 and 2016; a similar trend was seen for service exports, where the LDC share stood at 0.74 percent in 2016.¹⁵ In 38 of the LDCs for which data are available, economies are heavily reliant on the commodity sector, which accounted for more than two thirds of merchandise exports in 2013–2015;¹⁶ the cyclical nature of this sector can lead to government budgets shrinking during commodity downturns.

¹² Ibid.

¹³ United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018'.

¹⁴ United Nations (2018c). 'The Sustainable Development Goals Report 2018'.

¹⁵ Ibid.

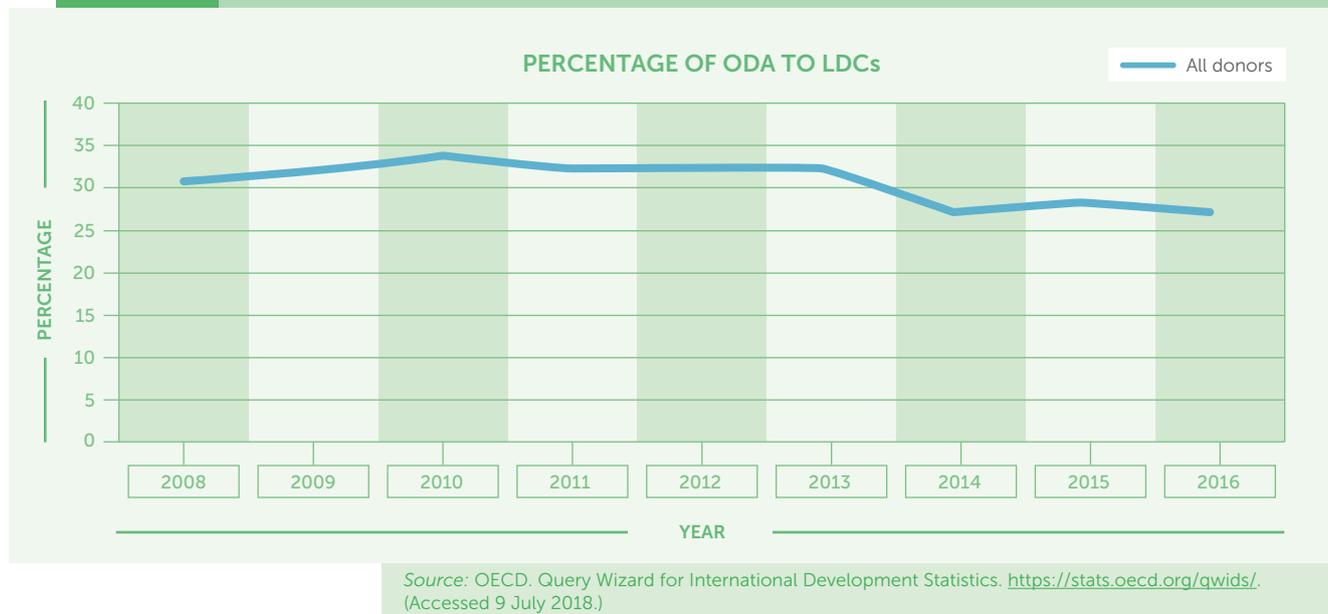
¹⁶ For more information, see United Nations Conference on Trade and Development (2016). 'The Least Developed Countries Report. The path to graduation and beyond: Making the most of the process'. Geneva: UNCTAD. http://unctad.org/en/PublicationsLibrary/ldc2016_en.pdf.

Financing shortfalls can be especially large at the subnational level. Many fast-growing cities in LDCs play an important role in delivering the SDGs, and face pressures from growing urbanization.¹⁷ The difficulty in raising debt at subnational level is reflected in the fact that there is no subnational public rating for an LDC from any of the three major ratings agencies, except for the Municipality of Dakar.¹⁸

Overall, the external resource gap—that is, the difference between the gross fixed capital formation rate and the gross domestic savings rate—of LDCs as a group averaged 6.9 percent of GDP in 2015, up from 4.9 percent in 2014.¹⁹ LDCs have traditionally financed this external resource gap through a mixture of official development financing²⁰— including ODA — and private resource flows, notably foreign direct investment (FDI) and remittances.²¹ However, none of these options is likely to bridge the SDG financing gap entirely.

Second, in LDCs, unlike in other developing countries, ODA is already the largest source of external finance; it accounts for over one third of external finance and remains essential for LDCs' development prospects. While gross ODA disbursements amount to only 1.3 percent of government revenue in all developing countries on average, this figure is much higher in LDCs, at around 15 percent.²² While there was an increase in ODA to LDCs in 2016 of less than 1 percent in real terms to \$43.1 billion, the medium-term trend is one of stagnation.²³ In addition, LDCs have received a declining percentage of total ODA flows from all donors over the past decade in real terms, as shown in Figure 1. ODA flows to LDCs are also unevenly allocated: for example, in 2015–2016, half of the gross bilateral ODA expenditures from OECD Development Assistance Committee (DAC) countries were directed at eight LDCs.²⁴

FIGURE 1. Percentage of ODA received by LDCs (2008–2016)



¹⁷ It is estimated there will be 71 cities with populations of between 0.5 million and 1 million people in LDCs by 2030, up from 30 in 2015 (Hilger, Tim, Vito Intini, Daniel Platz and Simona Santoro (2017). 'Financing Sustainable Urban Development in the Least Developed Countries'. New York: UNCDF and DESA/Financing for Development Office).

¹⁸ Ibid.

¹⁹ United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018'

²⁰ Official development finance is a term used by OECD to measure inflow of resources to recipient countries. It includes: bilateral ODA; grants and concessional and non-concessional development lending by multilateral financial institutions; and other official flows for development purposes (including refinancing loans) which have too low a grant element to qualify as ODA.

²¹ Here too individual LDCs show differences, with some oil- and mineral-rich LDCs having gross domestic savings far outstripping gross fixed capital formation (United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018').

²² United Nations Department of Economic and Social Affairs (2018). 'Financing for Development: Progress and Prospects 2018. Report of the Inter-agency Task Force on Financing for Development'. New York: UN-DESA. https://developmentfinance.un.org/sites/developmentfinance.un.org/files/Report_IATF_2018.pdf.

²³ Ibid.

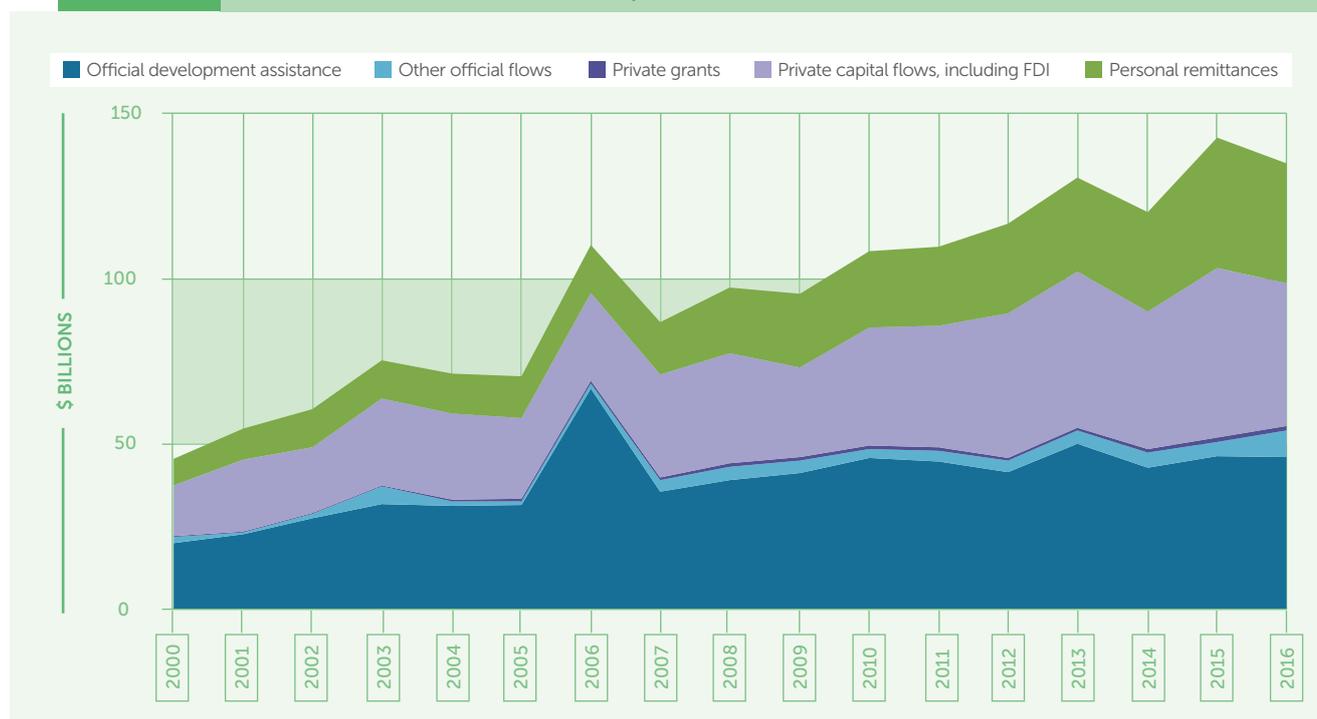
²⁴ Afghanistan, Ethiopia, Tanzania, Bangladesh, South Sudan, DRC, Mozambique and Uganda (Organisation for Economic Co-operation and Development (2018c). 'Development Co-operation Report 2018: Joining Forces to Leave No One Behind'. Paris: OECD Publishing. <https://www.oecd-ilibrary.org/docserver/dcr-2018-enpdf?expires=1539274159&id=id&accname=quest&checksum=F7B44E058615E4C52CDA3F6F9D4F3EC7>).

The Istanbul Programme of Action for LDCs seeks to enable half the LDCs to meet graduation criteria by 2020.²⁵ Even if this goal is not met, forms and modalities of ODA support might change for those LDCs²⁶ moving towards graduation.²⁷ LDCs will continue to have access to external support after graduation, and most development partners indicate that LDC status is not a main criterion for ODA allocation. However, some donors might switch from grants to concessional loans or increase interest rates for concessional loans.²⁸

Third, FDI, which has been on an upward trajectory in LDCs since 2002, remains concentrated in a small number

of economies and sectors, and can be volatile, reflecting macroeconomic and monetary conditions in both recipient and source countries. In 2017, FDI inflows to LDCs decreased for the second consecutive year, by 17 percent to \$26 billion. The value of greenfield FDI projects announced in 2017, an indicator of future FDI flows, plunged by 43 percent to a four-year low; foreign investors, mostly from other developing economies, have scaled down their capital spending plans, especially in the services sector.²⁹ It is also worth noting that remittances to LDCs as a group totalled \$36.9 billion in 2017, down by 2.6 percent compared with the 2016 peak of \$37.9 billion.³⁰

TABLE 2. External finance to LDCs, constant prices, 2000–2016



Source: Estimates based on OECD statistics and World Bank data on remittances and private capital flows.³⁰

²⁵ United Nations (2011). 'Fourth United Nations Conference on the Least Developed Countries, Programme of Action for the Least Developed Countries for the Decade 2011-2020'. A/CONF.219/3/Rev.1, 23 May 2011. New York: United Nations. <http://unohrls.org/UserFiles/File/IPoA.pdf>.

²⁶ Not all international organizations and financing institutions use the LDC category and criteria for aid and credit allocation. The list of LDCs is reviewed every three years by the Committee for Development Policy (CDP), a group of independent experts reporting to the United Nations Economic and Social Council. The CDP may recommend countries for addition to, or graduation from, the list of LDCs. At a meeting of the CDP in March 2018, four countries—Bhutan, Kiribati, São Tomé and Príncipe, and Solomon Islands—were recommended for graduation from the LDCs list. In addition, Bangladesh, Lao People's Democratic Republic and Myanmar met the graduation criteria for the first time. These three countries will be considered for graduation at the next triennial review in 2021, with a view to graduating in 2024. Nepal and Timor-Leste were found eligible for the second consecutive time but were not recommended for graduation. The Committee will consider Nepal and Timor-Leste again in 2021. See United Nations (2018d). 'Committee for Development Policy Report on the Twentieth Session (12–16 March 2018)'. E/2018/33. New York: United Nations. <http://undocs.org/en/E/2018/33>.

²⁷ As of May 2018, all LDCs except for Angola are eligible to receive IDA resources. Out of the five LDCs graduated so far, only two (Botswana and Equatorial Guinea) are also IDA graduates (United Nations (2018e). 'Implementation, Effectiveness and Added Value of Smooth Transition Measures and Graduation Support, Draft Report of the Secretary-General'. New York: United Nations).

²⁸ Ibid.

²⁹ United Nations Conference on Trade and Development (2018b). 'World Investment Report 2018. Investment and new industrial policies'. Geneva: UNCTAD. http://unctad.org/en/PublicationsLibrary/wir2018_en.pdf.

³⁰ United Nations Conference on Trade and Development (2018a). 'Selected Sustainable Development Trends in the Least Developed Countries 2018'.

³¹ Note: The figures shown are in net disbursements. Figures for ODA, other official flows (OOF) and private grants are based on OECD statistics and are net disbursements. ODA and OOF include outflows from bilateral and multilateral institutions; capital subscriptions are included in private grants. OOF flows were negative in 2000, 2001, 2004 and 2006, and are given a null value in the graph. Private grants cover gross outflows from non-governmental organizations (NGOs) and civil society minus support received from the official sector. Remittances are in gross disbursements. Private capital flows include net FDI and portfolio investments.

Institutional investors such as pension funds and insurance companies are large sources of private capital. While these investors favour liquid portfolios of bonds and equities, in some geographies they have become a meaningful source of capital for unlisted infrastructure projects.³² Such investments have largely bypassed the LDCs, however. Much of the infrastructure investment needed for the SDGs will be for sustainable infrastructure in the global South. One report estimates that at least an additional \$1 trillion a year of private-sector investment in sustainable infrastructure in emerging markets will be required.³³ Attracting long-term finance for projects in this sector, however, is very difficult. Only a few of the top 100 private institutional investors, including sovereign wealth funds, have more than 1 percent of their assets directly invested in infrastructure globally;³⁴ the figure of investments in LDCs is likely far lower. In addition, private financing for SDG investments globally can also be volatile from year to year.³⁵

All these factors underscore the fact that LDCs need access to significant additional resources—both private and public, depending on the nature of the projects to be financed—to achieve their goals. In Bangladesh, for example, the government estimates that about 42 percent of total finance for meeting the SDGs will have to come from the private sector, with another 6 percent coming in the form of public–private partnerships (PPPs).³⁶

Private and public finance have different objectives; the former is return-oriented and invests in projects or companies, such as small and medium enterprises (SMEs), that generate revenues, while the latter is concerned with providing public services and supporting sustainable development, including through public goods such as protecting ecosystems. Both types of finance are required to fill the SDG financing gap. In the case of private finance, a reallocation of even a small percentage of the \$80 trillion in assets managed by long-term institutional investors towards sustainable development in LDCs could have an enormous impact on their prospects of achieving the SDGs.³⁷

Against this backdrop, blended finance is receiving increasing attention for its potential to maximize the catalytic impact of concessional finance by sharing risks

or lowering costs to adjust risk–return profiles for private investors. This crowds in private or commercial capital for SDG-related investments that would otherwise be overlooked.³⁸ Scoping studies commissioned for this report in four LDCs suggest that interest in exploring blended finance as an additional avenue for mobilizing resources for the SDGs may be gaining momentum, though LDCs are also becoming more aware of the risks.³⁹

Beyond making an investment more attractive for private capital, blended finance can also bring other benefits. These can include sending a broader signal that a project, sector or market is investable. Through demonstration effects, lessons learned and knowledge-sharing, blended finance could support commercial replication over time, inform government-led improvements in policies and regulations, and potentially support the development of local markets, helping to make countries or sectors more attractive to private finance.⁴⁰

At the same time, blended finance is not suitable for all kinds of projects; at a minimum, projects must generate revenue streams to attract private investment. Some LDCs may not currently have the capacities, regulations or institutional arrangements to negotiate, analyse and structure blended transactions. Blended finance must also be applied effectively and efficiently. ODA should not be used in blended transactions to over-subsidize the private sector and/or provide an unfair advantage to some investors while crowding out others.

Blended transactions should comply with high standards of transparency and accountability; promote the fair allocation of risks and rewards; and apply high environmental, social and governance (ESG) standards. Given concerns around LDC governments not being fully involved in decisions about the allocation of concessional resources, or blended finance being a back door to tied aid, concessional providers and donors should ensure that blended transactions align with national priorities and respect national ownership.

To date, the role of blended finance in LDCs is quite limited: 7 percent (or \$5.5 billion out of \$81 billion) of the total private capital mobilized by official development finance globally over the 2012–2015 period benefited LDCs, according to OECD data (see Chapter 2). This is not necessarily an ‘underweighting’ relative to the size of their economies, though it is small relative to the amount of ODA LDCs received (see Table 3). This suggests that attracting private finance is more difficult in LDCs than elsewhere, and that providers are mobilizing much greater volumes of private finance in MICs.

³² Pension funds in some countries—notably Canada—have increased their allocation to infrastructure significantly.

³³ Blended Finance Taskforce (2018). ‘Better Finance, Better World: Consultation Paper of the Blended Finance Taskforce’. London: Blended Finance Taskforce. https://s3.amazonaws.com/aws-bsdc/BFT-BetterFinance_final_01192018.pdf.

³⁴ Ibid.

³⁵ Kharas, Homi (2018). ‘Cross-border financing flows impacting the Sustainable Development Goals’ in *Financing the UN Development System: Opening Doors*. New York: United Nations MPTF Office and Dag Hammarskjöld Foundation. https://www.daghammarskjold.se/wp-content/uploads/2018/09/financial-instr-report-2018-interactive-pdf_pj.pdf.

³⁶ Rahman, Mustafizur, Towfiqul Islam Khan and Sherajum Monira Farin (2018, forthcoming). ‘Blended Finance in Bangladesh: A scoping paper’. Southern Voice Occasional Paper, No. 46. Dhaka: Southern Voice. It is important to note that PPPs are established mechanisms to involve private parties in the provision of a public service or the building and operation of public infrastructure. Some PPPs can be structured as blended transactions.

³⁷ United Nations Department of Economic and Social Affairs (2018). ‘Financing for Development: Progress and Prospects, 2018’.

³⁸ See the guest piece by Jorge Moreira da Silva, ‘Targeting blended finance to help the poorest 20 percent’.

³⁹ Bhattacharya, Debapriya, and Sarah Sabin Khan (2018, forthcoming). ‘Is blended finance trending in LDCs? Perspectives from the ground’. Southern Voice Occasional Paper, No. 49. Dhaka: Southern Voice.

⁴⁰ Sierra-Escalante, Kruskaia, and Morten Lykke Lauridsen (2018). ‘Blended Finance—A Stepping Stone to Creating Markets’. Washington, DC: IFC. https://www.ifc.org/wps/wcm/connect/363eeaab-77da-4a9e-ad1e-9ff089402bf1/EMCompass_Note_51-BlendedFinance_FIN+April+13.pdf?MOD=AJPERES.

This reflects higher risks and perceptions of risk in LDCs, which can stem from a poor business enabling environment. Macroeconomic, governance, regulatory, infrastructure, market as well as other perceived risks can be a significant deterrent to private capital, even when risks are shared through blending. Additionally, in smaller LDCs the scale of the opportunity—overall size of the economy (notwithstanding its growth prospects) or sector—and small deal sizes relative to transaction costs may be insufficient to draw interest from international private investors. It may also reflect that there are fewer bankable opportunities in LDCs.

Some providers of concessional capital may also shy away from riskier markets, for several reasons: low risk appetite given the need to preserve their triple-A credit ratings; a lack of awareness of investable projects; institutional incentives to close deals, leading to a focus on 'easier' markets or projects; or mandates that favour commercial returns.⁴¹

Blended approaches can increase overall financing available for the SDGs. While efforts to map blended finance have not necessarily painted a complete picture, they do suggest that if blended finance becomes an increasingly important modality of development cooperation, development partners will need to ensure that this does not come at the expense of support for LDCs and other vulnerable countries—those most heavily reliant on ODA and where blending has been more challenging.⁴² This underlines the importance both of donors meeting their ODA commitments to LDCs and of exploring how to deploy blending more effectively and efficiently in such countries.⁴³

Blended approaches may not always be the right ones for leveraging private finance. In some cases, a project may simply not be ripe for blending. The cost of getting a deal off the ground by deploying concessional resources may be too high; in such cases, pure public financing might be a better option. There may, however, be other cases in LDCs where blended transactions are important to create demonstration effects that narrow the gap between actual and perceived risks of investing in these markets.

Ultimately, meeting the SDGs will require investments of all kinds—public and private, domestic and international. Project and country characteristics, macroeconomic conditions and national policy priorities should determine which financing model—public, private or blended—is best suited for which investment.

At its heart, this report is about challenging the public and private development partners to shift the dynamics of how resources are allocated and to come up with better ways of making finance work for poor people. This report, therefore, explores how to implement and adapt blended finance approaches to LDCs to maximize their effectiveness in crowding in private capital while minimizing their risks.

⁴¹ See, for example, Lee, Nancy (2018). 'More Mobilizing, Less Lending'. Center for Global Development Brief, April 2018. Washington, DC: Center for Global Development. <https://www.cgdev.org/sites/default/files/more-mobilizing-less-lending-pragmatic-proposal-mdbs.pdf>.

⁴² Oxfam (2017). 'Private-finance blending for development: Risks and opportunities', Oxford: Oxfam, February 2017. <https://www.oxfam.org/sites/www.oxfam.org/files/bp-private-finance-blending-for-development-130217-en.pdf>.

⁴³ United Nations Department for Economic and Social Affairs (2018), 'Financing for Development: Progress and Prospects, 2018'.

STRUCTURE OF THE REPORT

In addition to briefly outlining the key concepts of blended finance used throughout the report (Chapter 1), Part I examines the current data on the application of blended finance in LDCs (Chapter 2), analyses the barriers to private capital in LDCs and how blended finance can be used to address them throughout the investment life cycle (Chapters 3 and 4), discusses blended finance and development effectiveness in LDCs (Chapter 5) and, finally, highlights open issues requiring further discussion as they pertain to blended finance in LDCs (Chapter 6). Besides the data analysis led by the OECD, this part of the report draws on the scoping studies on four LDCs—Bangladesh, Nepal, Senegal and Uganda—prepared by research centres affiliated with Southern Voice, on the related synthesis paper produced by the Southern Voice secretariat, and on informal interviews with blended finance providers. It also weaves in findings and takeaways from case studies analysed in Part II, and the guest pieces presented in Part III.

Part II presents five case studies of blended finance in LDCs produced jointly by contributors and UNCDF: a water infrastructure project in Rwanda, a solar power infrastructure project in Mali, an agricultural value chain project in Tanzania, a currency hedging programme in Myanmar, and a private equity fund in the Democratic Republic of the Congo (DRC) and the Central African Republic (CAR). Each case study discusses a specific development challenge and related barriers, the blended finance solution adopted and key takeaways, to tease out some general considerations. The case study selection was motivated by three criteria: assembling a fairly diverse geographical sample; analysing LDCs characterized by different social and macroeconomic conditions and enabling environments; and examining the application of blended finance in different sectors.

Part III introduces short opinion pieces produced by experts and practitioners covering a range of topics. This is meant to stimulate the debate on blended finance in LDCs, by providing a venue for think tanks, development finance institution (DFIs), national development banks, investors, and bilateral and multilateral development organizations to discuss specific questions emerging from their activities.

Part IV summarizes UNCDF's proposed action agenda to improve the effectiveness and efficiency of blended finance in LDCs, address risks flagged in the report, fill data and information gaps and consider some future avenues of research and analysis.