Scaling Up Green Investment in the Global South: Strengthening Domestic Financial Resource Mobilisation and Attracting Patient International Capital

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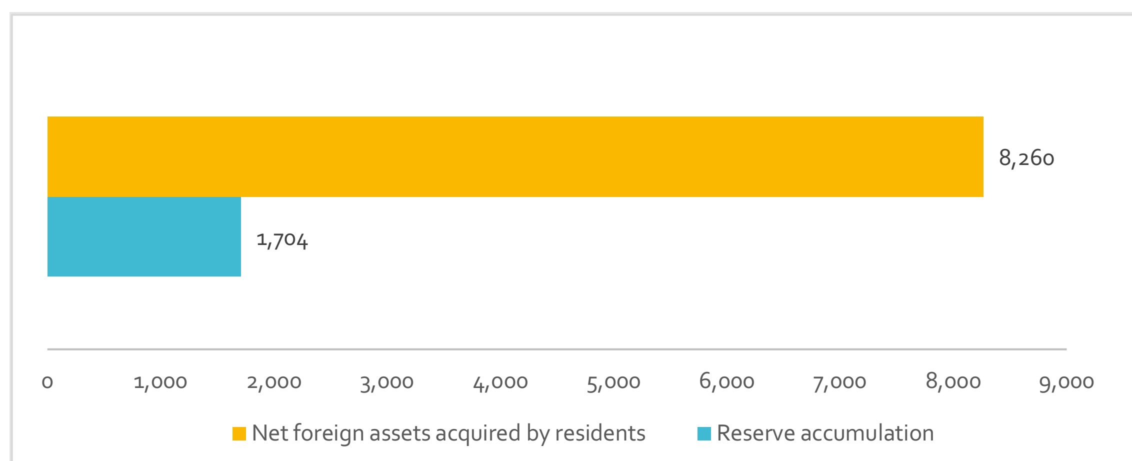
Executive summary

There is an urgent need to scale up green investment in the Global South. The annual funding shortfall in developing countries grew from USD 2.5 trillion before the pandemic to USD 3.9 trillion (OECD 2022). Yet, developing countries' access to international sources of capital is more challenging than ever. It becomes increasingly clear that the Agenda 2030 and the Paris climate goals cannot be met without strengthening domestic financial resource mobilisation and finding better ways of attracting patient international capital.

Channelling more domestic savings into domestic investment holds substantial potential for improved outcomes. Large amounts of developing country savings are currently invested – often at low or negative returns – in financial centres in advanced countries (Volz and Schoenmaker, 2022). These capital exports are often channelled back to developing countries in the form of high-yielding, short-term debt or portfolio investment, which increase financial vulnerabilities.

Between 2010-2021, the foreign asset and reserve acquisitions of emerging and developing economies (EMDEs) other than China were almost USD 10 trillion: Net foreign assets acquired by residents increased by USD 8.3 trillion while reserve asset holdings increased by USD 1.7 trillion (Figure E1). These are domestic savings invested abroad – largely in hard-currency assets – instead of the local economy. In other words, while capital should be flowing from advanced countries, where it is abundant, to developing economies, where investment needs are much larger, a lot of capital is flowing in the other direction – it is flowing 'uphill'. Even in countries that are net capital importers (including most countries in sub-Sahara Africa), significant amounts of domestic savings are invested abroad in safe, hard-currency assets, instead of the local economy.

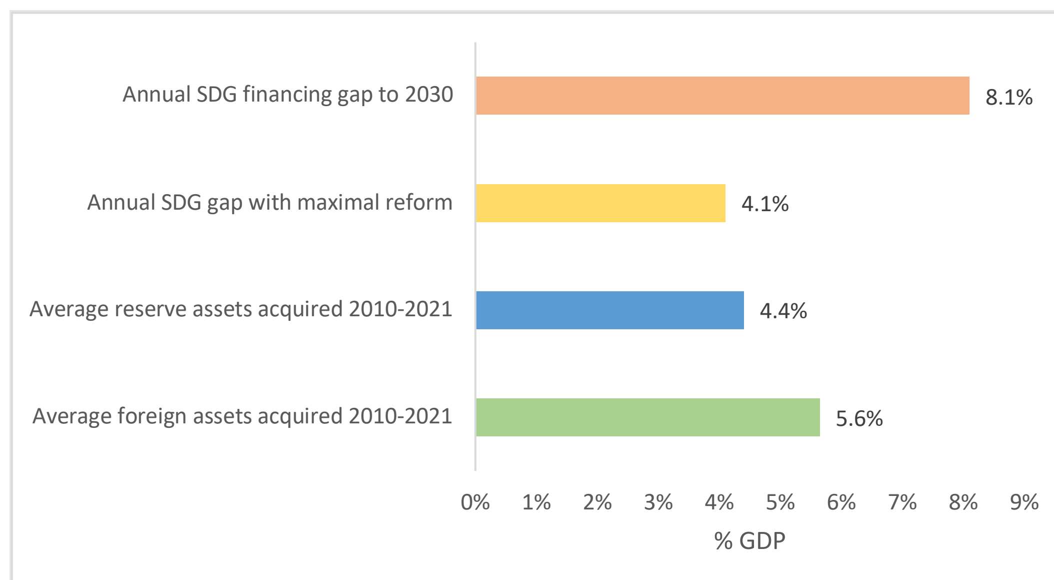
Figure E1: Net foreign assets and reserve assets acquired by EMDE excl. China (billion USD), cumulative 2010-2021



Source: Compiled by authors based on own calculations with data from IMF BPM06.

78 EMDEs acquired foreign and reserve assets greater than 2% of GDP a year – capital that could have been in part invested domestically. In some countries, foreign and reserve asset acquisitions even exceed the amount of funding required to meet the SDGs. For instance, the IMF estimates that Cambodia faces an annual financing gap of 8.1% of GDP to meet SDG goals in five core areas by 2030 (Benedek et al. 2021). This compares to average annual foreign assets acquired of 5.6% and average reserve assets acquired of 4.4% – a total 10% (Figure E2).

Figure E2: Comparing the SDG financing gap and net foreign asset acquisitions: The case of Cambodia



Source: Compiled by authors based on own calculations with data from Benedek et al. (2021) and IMF BPM06.

Efforts need to be undertaken to channel more domestic savings into domestic investment. There are various reasons why developing countries export capital, including a desire to build up foreign exchange reserves to build buffers and cushion against shocks, domestic instability, illicit flows, and a lack of long-term investment opportunities at home due to underdeveloped capital markets. A major problem for most developing countries is that they face a shortage of safe, investable assets. The inability to issue safe assets imposes a major constraint on the resilience of local capital markets to external shocks (Rojas-Suarez 2014).

Public Development Banks (PDBs) in developing countries can assume a key role in mobilising domestic savings and channelling them into domestic investment. Domestic PDBs have specific comparative advantages over internationally operating counterparts, including their ability to provide local currency finance, a deep understanding of the local political economy, and their proximity to local markets and embeddedness in the national context. This proximity often allows them to more readily develop and scale domestic pipelines of projects and target projects

with high sustainable development impact and reach beneficiaries at the local and municipal level (OECD 2019).

To fully harness their potential, PDBs need stronger, more coherent mandates that are aligned with the sustainable development and climate goals to deliver transformative action. Moreover, many PDBs need to strengthen their capacities across corporate governance, financial management, credit risk, monitoring, auditing, credit recovery, knowledge and best practice dissemination.

This role of PDBs can be enhanced with support from Multilateral Development Banks (MDBs) and the development finance institutions (DFIs) of advanced countries. MDBs/DFIs have experience in delivering technical assistance projects and capacity building for banking and financial management. In addition to supporting strong governance structures, they can help PDBs to boost expertise in financing green infrastructure and projects. They can also support developing country governments in establishing a new green investment bank from scratch.

MDBs/DFIs can support PDBs to improve their ability to raise low-cost capital. For PDBs to assume a catalytic role in financing the green transition and effectively leverage the capital provided by their shareholders, they need to be able to obtain refinancing at competitive rates. However, they face a serious obstacle: The funding cost of financial institutions in developing countries are constrained by a sovereign ceiling effect which has a direct impact on their cost of capital (Almeida et al. 2017). Since PDBs are usually fully government-owned, their credit risk cannot be better than that of the government. This impedes the part nationally owned PDBs could assume in financing and accelerating the green transition. MDBs and DFIs could help PDBs to obtain cheaper refinancing conditions in markets by providing equity and build a strong standing in capital markets. Besides the actual capital contribution, the involvement of the MDB/DFI would also reassure capital markets regarding high standards of governance of the PDB. An alternative that would allow the government to retain full ownership of the PDB would be that the MDB/DFI could offer callable capital in exchange for seat(s) on the PDB's board. This should lift the PDB's rating, compared to a situation without MDB/DFI involvement. This would be analogous to the treatment of callable capital at MDBs.

Box E1: Examples of support for national and regional development banks

Examples exist of MDBs and DFIs providing equity to national and regional development banks or providing support through co-finance and technical assistance. The Development Bank of Nigeria (DBN) – which is modelled on Germany's KfW – was established in 2015 with equity participation from the European Investment Bank and the African Development Bank and debt capital from KfW, the World Bank and the Agence Française de Développement. More recently, KfW, the World Bank Group, the African Development Bank and the European Investment Bank supported the establishment of the Development Bank of Ghana in 2022. The African Development Bank, the Netherlands Development Company (FMO) – and until recently the German Investment and Development Company (DEG) – are shareholders of the East African Development Bank, along with commercial investors and the four member countries of the East African Community (Kenya, Uganda, Tanzania and Rwanda).

MDBs/DFIs can also provide guarantees that will help PDBs to issue local currency debt at lower cost and in greater quantities. The International Development Association's recent first-loss guarantee for a local-currency sustainability-linked bond issued by the Development Bank of Rwanda (DBR) – helping the DBR in diversifying its funding base away from a reliance on international DFI funding and contributing to Rwanda's local capital market development – is an excellent example that should be replicated elsewhere and at scale.

Such partnership models between MDBs/DFIs and PDBs offer many advantages. They dovetail the development goals of the MDBs and DFIs with the need to build capacity and expertise at the national and sub-national level. Through targeted, long-term financing and technical support from MDBs and DFIs, PDBs can become major vehicles to leverage private capital and channel domestic savings into sustainable development.

To strengthen local capital markets and alleviate foreign exchange risk for developing country governments, MDBs and DFIs should, where possible, issue more local currency debt to raise capital for local currency lending. By doing so, they eliminate exchange risk, provide safe, investable assets for both local and international investors, and support local market development. Where this is not possible, MDBs should lend in local currency nonetheless and retain the currency risk. Since MDBs have a large regional or global lending portfolio, they can pool currency risk across countries (Perry, 2009).

Digital technologies provide an opportunity for developing countries to develop new, innovative fundraising approaches and reinvent how capital market infrastructure and instruments are built to serve the specific financing needs in these markets, as well as the needs of the local investor base (Chen and Volz, 2021; Dikau et al., 2022a, 2022b). Two of the largest problems for non-government local currency bond markets in EMDEs is creating an investor base and secondary market (Hashimoto et al. 2021). If new debt issuances do not bring in new investors, the applicable interest rate will be a function of local market conditions (Laurent and Lehmann 2006). Fintech solutions have demonstrated a capacity facilitate domestic resource mobilisation for sustainable investments and at the same time improve the implementation of infrastructure projects throughout the entire life cycle by facilitating processes and enhancing transparency (Chen and Volz, 2021). For instance, the Government of Kenya has raised money for infrastructure projects by issuing retail bonds that could be bought by small-scale individual investors on their mobile phone. Such approaches have the added benefit of not only unlocking more local currency capital, they also help to diversify the investor base with local investors (Dikau et al., 2022a). This also helps to shift accountability and interest payments from often being a relationship between the government (for government securities) and foreign creditors to also becoming a relationship between the government and the national population.

Tokenised local-currency SDG or sustainability-linked bonds issued by PDBs could target retail investors and remittances. The tokenisation of bonds and shares can enable citizens in emerging markets to become investors with smaller

amounts of savings, while digital aggregation of these micro-investments helps to raise additional sustainable investment capital. One way to address this is through tokenising PDB bonds and offering them on distributed ledger systems directly to retail investors in EMDEs. Further, it may be possible to link these systems to money transfer service providers to channel remittances into these bonds. This is comparable to the use of diaspora bonds (Ketkar and Ratha 2010). DFIs and MDBs can act as anchor investors and support new digital approaches for the tokenisation of bonds and the aggregation of micro-investments, sending a signal to other private investors about the viability and credibility of the instruments, ultimately crowding in new investors.

It is imperative that we find better ways of directing domestic savings into domestic investments across EMDEs. Creating safe, local-currency assets that attract domestic savings is one critical element. With the support of MDBs and DFIs, and by using innovative digital approaches, national PDBs can be powerful vehicles to overcome investment barriers and leverage private domestic and international finance for development by borrowing from capital markets. A strengthening of PDBs can accelerate and scale up green investment in emerging and developing countries.

Through the use of equity, callable capital or guarantees, PDBs can leverage the resources supplied by MDBs and DFIs. With these funds, PDBs can act as local partners and investors in low-carbon climate resilient projects, and are well placed to generate, monitor and audit significantly expanded project pipelines. Furthermore, it will be important to strengthening the global financial safety net to reduce the need for EMDE central banks to hold large amounts of foreign exchange reserves – which tend to be invested in low-yielding sovereign bonds of the major advanced countries.

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