First session of the Preparatory Committee for the fourth International Conference on Financing for Development

Multi-Stakeholder Round Table Discussion on "Domestic and International Private Business and Finance"

Thursday, 25 July 2024, 11:30 – 13:00

Issue note

Background

The Addis Ababa Action Agenda (Addis Agenda) emphasizes the role of private business activity, investment and innovation in driving productivity, inclusive economic growth and job creation. It invites private businesses to engage as partners in the development process, to invest in areas critical to sustainable development, and to shift to more sustainable consumption and production patterns. At the same time, it underscores that the existing financial system often does not intermediate finance in ways that are aligned sustainable development.

To support a sustainable transition, the Addis Ababa Action Agenda highlights the importance of government policies to:

i) Foster an enabling environment for private investment

Governments are encouraged to implement strong domestic policy frameworks and an enabling business environment, including regulatory and policy frameworks that both encourage private investment and better align it with public goals. Countries further agree to develop or strengthen long-term bond markets as a source of development finance, along with capital market regulations designed to reduce excess volatility and to promote incentives along the investment chain aligned with long-term investment and sustainable development.

ii) Mobilize private investment for sustainable development at scale

Along with a stronger enabling business environment, the Addis Agenda calls for greater use of public funds to mobilize private finance, through risk-sharing mechanisms such as blended finance. However, it also underscores risks associated with blended finance, noting the importance of country ownership, as well as well-designed instruments that share both risks and reward fairly and include clear accountability mechanisms.

iii) Align business and finance with sustainable development

The Addis Agenda encourages businesses to embrace a core business model that accounts for the environmental, social and governance impacts of their activities. Governments agree to promote sustainable corporate practices, such as on integrating environmental, social, and governance factors into company reporting. They also commit to working towards harmonizing initiatives on sustainable business and finance and strengthening the mechanisms and incentives for compliance.

iv) Advance financial inclusion

Member States commit to improving financial inclusion, particularly for women, youth, and underserved populations, to ensure broad access to financial services. The Agenda also includes a package of measures aimed at strengthening access to finance for micro, small and medium-sized enterprises (MSMEs), including through the use of development banks and innovative instruments. Acknowledging the importance of financial inclusion, countries commit to consider financial inclusion as a policy objective in financial regulation. The agenda acknowledges the importance of robust risk-based regulatory frameworks for financial intermediation while also noting that regulations change incentives, which can impact investment in sustainable development. Member States thus agree to work to ensure that policy and regulatory environments support financial market stability and promote financial inclusion in a balanced manner.

How have we done?
Key trends:

Private investment and dynamism slowed substantially after the 2008/09 crisis, with only a partial subsequent recovery (figure 1) and investment growth rates remaining substantially below pre-2008 levels. For example, FDI growth slowed significantly after the 2008/09 crisis, following rapid growth in the 1990s and early 2000s (figure 2). The shift towards digital business models and asset-light forms of production, a rise in protectionism, and policy uncertainty contributed to this slowdown. The recent COVID-19 pandemic further slowed – and in some cases reversed – gains from private sector development in many developing countries.

Figure 1. Private investment growth slowed in most regions during the 2010s *(Percentage)*

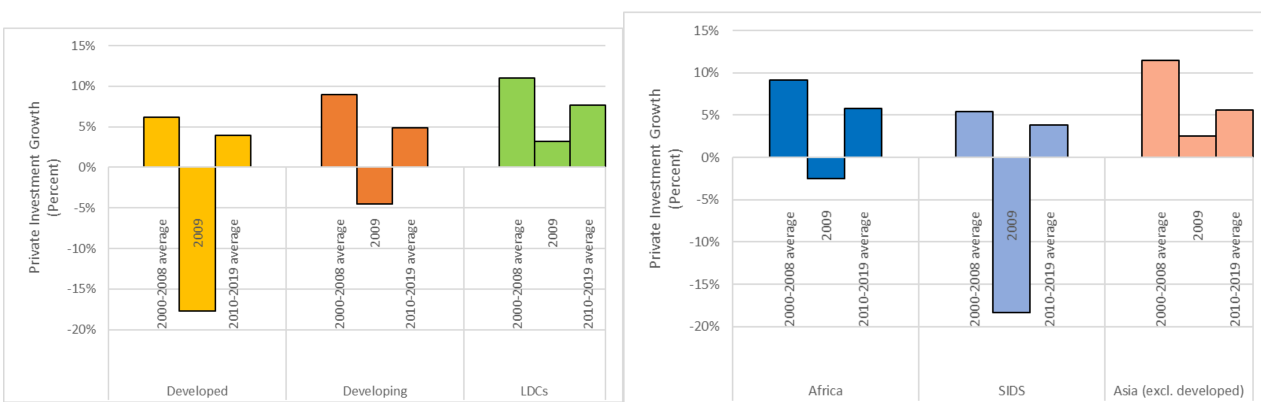
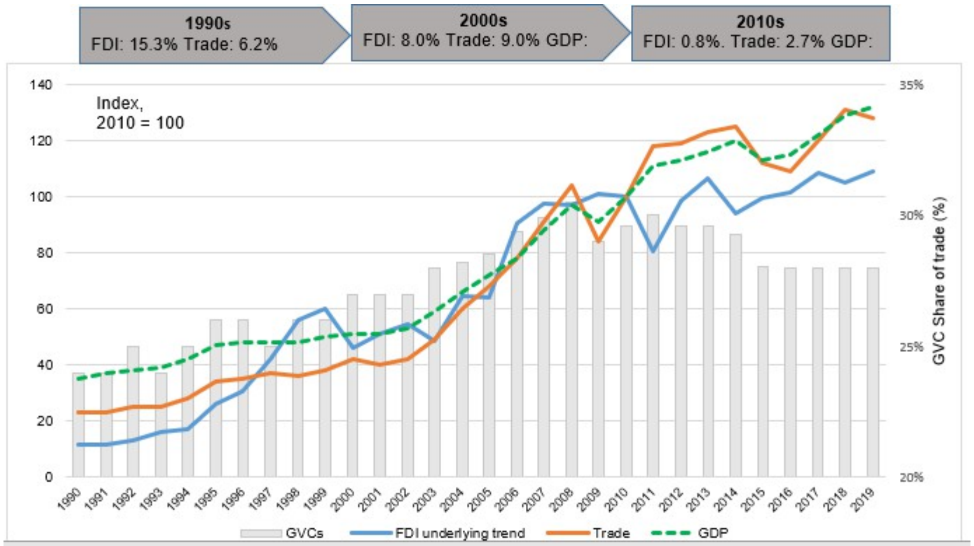


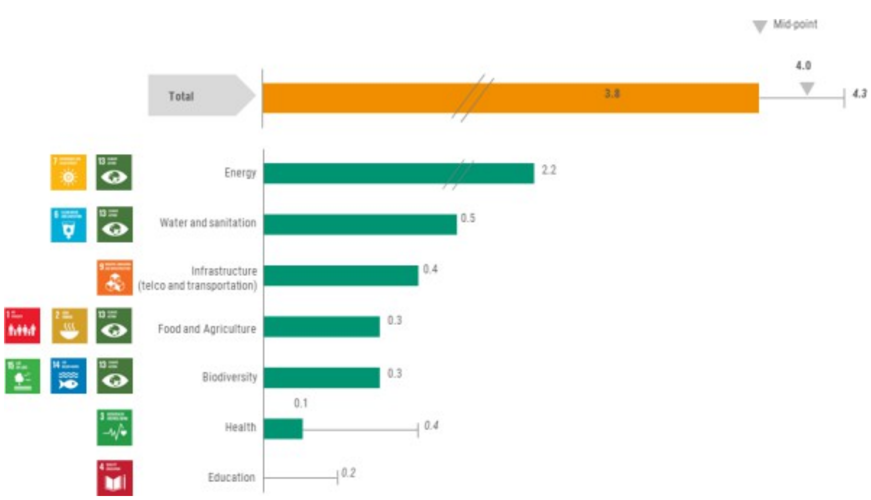
Figure 2. Foreign direct investment and trade trends, 1990–2019



While developing countries as a group have increased their share of FDI, including due to the rise of China as major recipient of inward FDI, least developed countries (LDCs) have witnessed only marginal investment growth. Essential sectors like healthcare and education continue to be underinvested, despite their critical importance for sustainable development.

Annual investment gaps across all SDG sectors increased from $2.5 trillion in 2015 to more than $4 trillion today, due to both underinvestment and growing needs (figure 3). Investment needs continue to be particularly large in the area of energy and infrastructure. While international investment in the renewable energy sector has nearly tripled since the adoption of the SDGs and the Paris Agreement, this growth has been unbalanced, with much of it concentrated in developed countries.

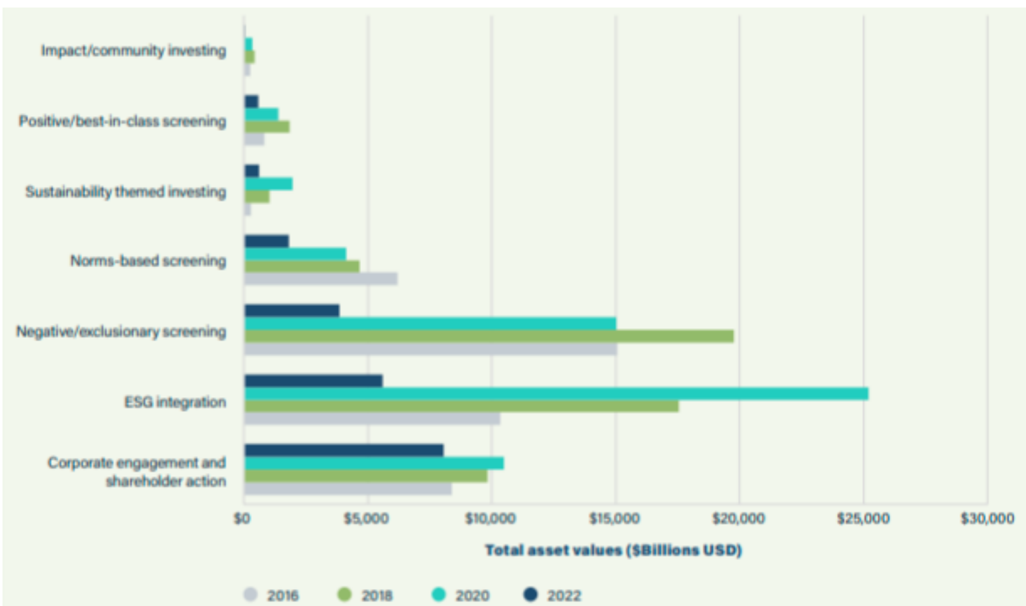
Figure 3. Estimated annual investment gap (public and private) in key SDG sectors
(Trillions of United States dollars)



Sustainable investing reached $30.3 trillion in 2022, marking a significant increase since its acceleration began in 2016, though still below the record highs seen before the COVID-19 pandemic. However, as of 2023, sustainable fund assets are estimated to be less than 5 per cent of the global fund market.

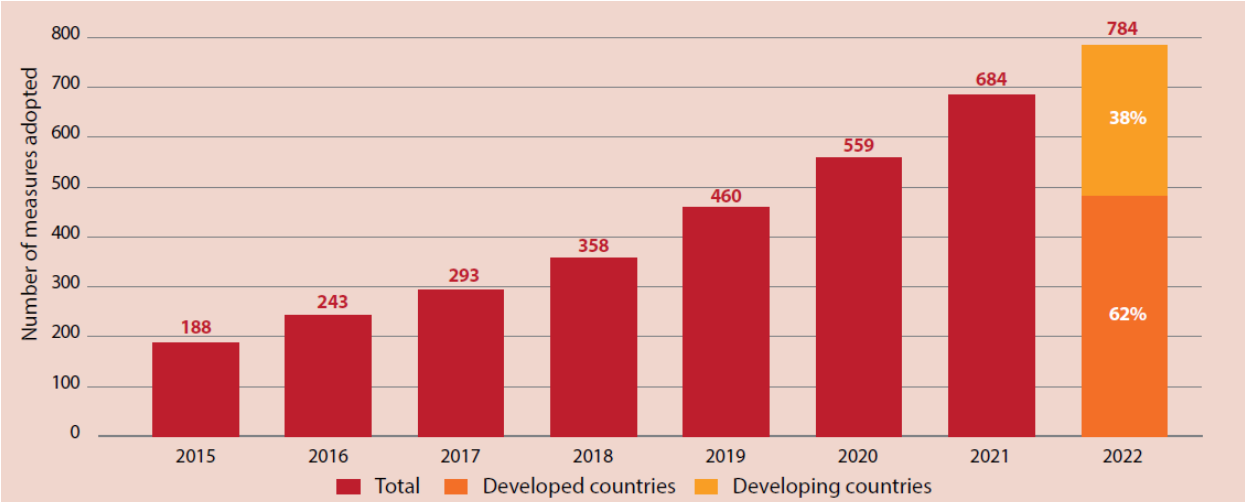
The majority of sustainable investment is tied to risk mitigation from sustainability factors, with sustainable asset managers prioritizing "ESG integration", which consists of integrating ESG factors into investment decisions to manage risks and possibly enhance financial returns. Negative screening is the second most popular strategy. "Impact investing", which aims to maximize SDG impact alongside financial returns, remaining small (figure 4).

Figure 4. Sustainable investing assets by strategy, 2016–2022 *(Billions of United States dollars)*



In terms of policy trends, sustainable finance legislation is increasingly being adopted at the regional and national levels (figure 5). The growing regionalization of sustainable finance legislation, however, reveals disparities and fragmentation across jurisdictions. With uneven progress across regions, promoting universal coverage will require bolstering institutional means, legal frameworks and capital markets, including through capacity building support and technical guidance.

Figure 5. Sustainable finance policy measures *(number of measures adopted)*



Actions and Challenges

Creating an enabling environment for private investment

Since the adoption of the Addis Ababa Action Agenda, many countries have made strides in improving their regulatory frameworks to attract private investment. Reforms aimed at reducing red tape, enhancing legal protections for investors, and promoting fair competition have been implemented in various regions. Nonetheless, regulatory and institutional weaknesses persist in many developing countries, which can deter private investment.

Nonetheless, the cost of capital for developing countries remains significantly higher for developing than developed countries. For instance, the cost of capital for renewable energy projects can be two to three times higher in developing countries than in developed countries. This disparity hampers the ability of countries to attract private investment for infrastructure and sustainable development projects. Local financial markets in many developing countries remain shallow and illiquidity, limiting their ability to provide stable funding for businesses. Domestic efforts to extend maturity structures towards longer-term finance have been hampered by several factors including market inefficiencies, an absence of local currency financing and institutional gaps, as well as macroeconomic volatility.

Structural changes in the global economy, including the concentration of manufacturing, technological advancements, and unequal gains from global value chains, challenge developing countries' integration and require new development strategies. Targeted policies to promote private sector development – so-called green or sustainable industrial policies – are experiencing a revival across the world, however many developing countries face fiscal and capacity constraints that risk creating unlevel playing fields. There are calls for increased international support to scaling up private capital, such as through blended finance.

Mobilizing private investment for sustainable development at scale

Despite some progress in leveraging private finance using public funds, blended finance has not been successful in catalyzing private investment at the scale required. Approximately $213 billion in capital has been mobilized, far below the trillions projected to be unlocked a decade ago. In addition, only a small proportion of this mobilized capital has been channeled to LDCs.

Reforms at MDBs have focused on new ways to raise private resources, with some considering numerical targets. However, it is likely that such targets would incentivize deals that are easier to implement with high leverage ratios, which are more likely to be in lower risk middle income countries. A new approach to blended finance is needed, tied to principles laid out in the Addis Agenda, with a primary focus on development impact rather than quantity or degree of leverage (which favors lower-risk projects, often with lower development impact). This would also include ensuring: alignment with country priorities as part of broader national sustainable development strategies; measurement of the cost of blending versus other financing mechanisms; and designing instruments to ensure that the public sector is not overcompensating the private partner.

Aligning business and finance with sustainable development

Over the last decade, businesses have increasingly embraced sustainability considerations, recognizing their long-term benefits, fueled in large part by increasing climate risks. Corporate sustainability initiatives, including but not limited to commitments to net-zero emissions and sustainable supply chains, have gained momentum. Financial institutions are rolling out new products and services aligned with sustainability goals, displaying a range of ambition from negative screening to impact strategies.

Nevertheless, the potential risks of misalignment, regression, and greenwashing highlight the imperative to redefine the "rules of the game." Aligning private sector activities with the SDGs remains a challenge. Most companies are geared to seek (often short-term) financial gains over long-term sustainability goals. Ensuring that business strategies and investments are fully aligned with the SDGs requires stronger regulatory frameworks, incentives, and accountability mechanisms. Policymakers have various tools available, including pricing externalities through mechanisms like carbon pricing, phasing out harmful subsidies, prohibiting activities with negative impacts, and subsidies and public investments.

Deficiencies in the sustainability information infrastructure exacerbate concerns over greenwashing. In response, the field has commenced a journey towards maturation, marked by the refinement and consolidation of voluntary reporting standards, as called for in the Addis Ababa Action Agenda. The International Sustainability Standards Board (ISSB), established at COP26 in Glasgow, has made significant strides at standardizing non-financial reporting, with several countries currently contemplating adoption. The ISSB's framework adopts a financial materiality lens, focusing exclusively on the impact of non-financial risks—particularly climate-related ones—on businesses' financial performance to facilitate investor decision-making. It does not encompass impact on sustainability, such as private sector environmental and social externalities, or positive contributions to the SDGs.

Additionally, challenges endogenous to the field of sustainable finance, like the lack of consistency in definitions and the proliferation of various management and measurement standards, hinder coherence and transparency. The integration of sustainability into business models and investment decisions remains inconsistent. The lack of standardized reporting on sustainability topics makes it difficult to assess and compare the sustainability performance of businesses. There is a need for harmonized management standards and mandatory disclosure requirements to ensure that sustainable finance truly supports sustainable development outcomes.

Financial inclusion

Significant progress has been made in financial inclusion, driven by innovations in digital finance and fintech. These innovations have expanded access to financial services for individuals and businesses, particularly in LDCs. For example, mobile money services have enabling millions of people in Sub-Saharan Africa to access banking services for the first time.

However, access to long-term finance remains a challenge, especially for SMEs in developing countries where credit favors large firms. SMEs continue to face significant barriers to accessing finance, including high collateral requirements, lack of credit history, and limited financial literacy. Gender, age, and location still affect access to financial resources. Women, youth, and rural populations continue to face barriers to accessing financial services. The gender gap in account ownership halved from 8 to 4 points, but remains significant: in 2021, 78 per cent of men and 74 per cent of women had access to financial services. Migrant remittance costs fell from 7.7 per cent in the second quarter of 2015 to 6.2 per cent in 2023, are still significantly above the 3 per cent target of the Addis and 2030 Agendas.

The way forward and guiding questions for discussion

In view of the multiple challenges related to i) creating an enabling environment for private investment; ii) mobilizing private investment for sustainable development at scale; iii) aligning business and finance with sustainable development; and iv) promoting financial inclusion, a number of solutions have been proposed. These include measures to improve blended finance structures and “make blended finance work or sustainable development”, the establishment of a currency fund to allow private investors to hedge currency risk, measures to better link profitability to sustainability, and leveraging digital technology to provide universal access to financial services, among others.

1. Creating an enabling environment for private investment

- What additional measures are needed to strengthen domestic markets and attract more investment to developing countries in the current global economic landscape?
- What actions are needed to create an enabling environment for business, and more specifically for sustainable investment and business activity, including in developing countries?
- What reforms are needed to international trade and investment rules to provide developing countries with sufficient policy space to pursue sustainable industrial transformations, while avoiding a rise in protectionism and further fragmentation of the global economy?

2. Mobilizing private investment for sustainable development at scale

- What are the impediments to scaling up blended finance, including in LDCs, and what actions can help scale up and increase the impact of blended finance projects?
- What measures and instruments can increase country ownership and ensure that risks and returns of blended finance are shared fairly?
- What concrete actions can help lower the high of capital and related issues such as currency risk in developing countries?
- How can Member States improve project pipeline preparation and capacity building in alignment with country platforms and priorities, in collaboration with national regional, and multilateral development banks, and the UN system?

3. Aligning business and finance with sustainable development

- What additional or reinforced measures are needed to align private incentives with sustainable development, ensuring that the significant interest and multiple efforts in sustainable business and finance result in lasting changes to business behavior and investment patterns?
- How can the volumes of impact investment be increased to achieve real-world impact on the SDGs and how can greenwashing be more effectively avoided?
- What measures are needed to enhance the interoperability of sustainability legislation for the private sector across jurisdictions?
- How can the international sustainability data architecture be improved to reduce the current fragmentation across jurisdictions on both alignment legislation (e.g. taxonomies) and reporting legislation, to facilitate decision-making by international businesses and investors?

4. Financial inclusion

- How can long-term finance be promoted in domestic markets and bank lending to the private sector increased, while also providing access to long-term credit for both sovereigns and corporates?
- How can the size, liquidity, and maturity of financial and capital markets be enhanced in developing countries and what policies can achieve these aims?
- What opportunities do central bank digital currencies present to promote universal access to banking services?