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The Role of DFIs in Fragile Economies

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Acronyms

AfDB	: African Development Bank
CDC	: Commonwealth Development Corporation
DBSA	: Development Bank of Southern Africa
DFIs	: Development Finance Institutions
FDI	: Foreign Direct Investment
GTFP	: Global Trade Finance Program
ICT	: Information and Communications Technology
IFC	: International Finance Corporation
MCIT	: Ministry of Communications and Information Technology
MENA	: Middle East and North Africa
ODA	: Overseas Development Assistance
OECD	: Organisation for Economic Co-operation and Development
OPRC	: Output and Performance Based Road Contracts

Abstract

The objectives of this research are to investigate and establish an approach on how development finance institutions (DFIs) can navigate fragile environments, identify, and participate in investment sectors with the most growth potential within these fragile economies. The research first analyzed state fragility and the measures required to escape it from an economic, political, and social point of view. The study further highlighted key roles and approaches required by DFIs when investing in fragile economies. The study also investigated key challenges facing DFIs in fragile economies and recommended key policy considerations for improving development finance in these economies. The study found that DFIs have significant roles they can play in fragile economies such as supporting pioneering firms, providing patient, flexible and risk tolerant financing and addressing gender inequalities. DFIs also have the added roles of supporting trade finance, providing advisory services to firms and governments, and promoting infrastructure development. The lessons learnt from this research strengthen the DBSA Investment Committee when reviewing transactions from these environments.

1. Introduction

Despite efforts to elevate global poverty over the past few decades, there is a growing number of the world’s population which continues to live in extreme poverty. Of those living in extreme poverty, 76,5 percent are in fragile economies where almost one-quarter of the world’s population lives (OECD, 2020). Fragile states differ considerably from each other but tend to share common features such as a divided society with opposing views and no shared identity. These states have inadequate government capacity and lack the capacity to perform basic functions such as taxation, and providing security, the rule of law and economic infrastructure. These states also lack legitimacy with many of their own citizens and have few formal enterprises. The workforce cannot therefore reap the economies of scale and specialization which results in an unproductive and impoverished population (Collier, *et al*., 2019).

DFIs have a mandate to achieve development impact including in the world’s most fragile states to bring job and economic opportunities to societies that need them most. However, investing in these states is complex with significantly higher associated risks and costs. Unlike commercial lenders, DFIs are more tolerant of higher risks as they often pool financing and operate under explicit development mandates. They can also leverage their capacity to use public funding to de-risk investments while using their expertise, networks, and influence to mobilise collaborative approaches to project co-investment.

The objective of this study is to first investigate and establish an approach as to how can DFIs navigate fragile environments and which roles they should play in such economies. Secondly, to determine how DFIs can identify and participate in investment sectors with the most growth potential within these fragile economies.

2. Background

The term fragile economies can generally describe a heterogeneous group of countries with problems of governance, security, and development. Initially, the fragile state agenda mainly focused on conflict and post-conflict countries. But this has since been broadened to cover aspects of security, economic and social development as well as political representation and governance (Msier, 2010). African scholars such as Ncube and Jones (2013) have found fragility difficult to define due to the term being fluid and partly because it represents a continuum, with states possibly moving in and out of fragility. This depends on a nation's ability to respond to internal and external shocks. The main attributes of fragility however include the inability to deliver basic services due to weak capacity and institutions as well as poor policies and political instability.

The OECD (2020) described fragility as the combination of exposure to risk and insufficient coping capacity of the state, systems and/or communities to manage, absorb or mitigate those risks. It further stated that fragility can lead to negative outcomes including violence, poverty, inequality, displacement, environmental and political degradation.

The African Development Bank (AfDB) defines fragility as a condition of elevated risk of institutional breakdown, societal collapse, or violent conflict. Furthermore, fragility is an imbalance between the strains and challenges (internal and external) faced by a state and society, and their ability to manage them. The AfDB shifts the concept paradigm from "fragile states" to "fragile situations" to reflect that fragility can manifest at the local, national or regional level in any country regardless of its political or socio-economic standing (AfDB, 2022).

The DBSA defines fragility as countries or situations with unique development challenges that are exposed to risk arising from fragility and conflict where institutions of governance and communities are unable to manage or mitigate those risks. Fragility contexts can impact negatively on development outcomes including through violence, poverty, inequality, displacement, and environmental and political degradation (DBSA, 2021). Figure 1 shows the DBSA classified fragile states in the African continent as at March 2020.

Figure 1: DBSA identified Fragile States as at March 2020

Source: DBSA (2021)

The classification of fragile states by the DBSA, further reinforces the separation between fragile states and fragile situations. As stated by Ncube and Jones (2013), the term fragility is fluid and partly because it represents a continuum, with states possibly moving in and out of fragility. Fragile situations can be present in a country, without the country being classified as a fragile state. The ability of a country to manage fragile situations or elements will determine the country's ability to move out of fragility or stay in fragility and manifest itself into a fragile state. This is evident in a country like South Africa, which is faced with elements of fragility like poverty, gender-based violence and unemployment, but is not classified as a fragile state due to its strong and functional policies, institutions and governance structures.

Fragility also includes vulnerability to climate change and natural disasters. Economic growth theory has shown that accumulation of physical and human capital as well as technical progress may have a positive impact on growth. Fragile states have however accumulated less capital than others and have lower rates of technological progress which hinders their growth potential.

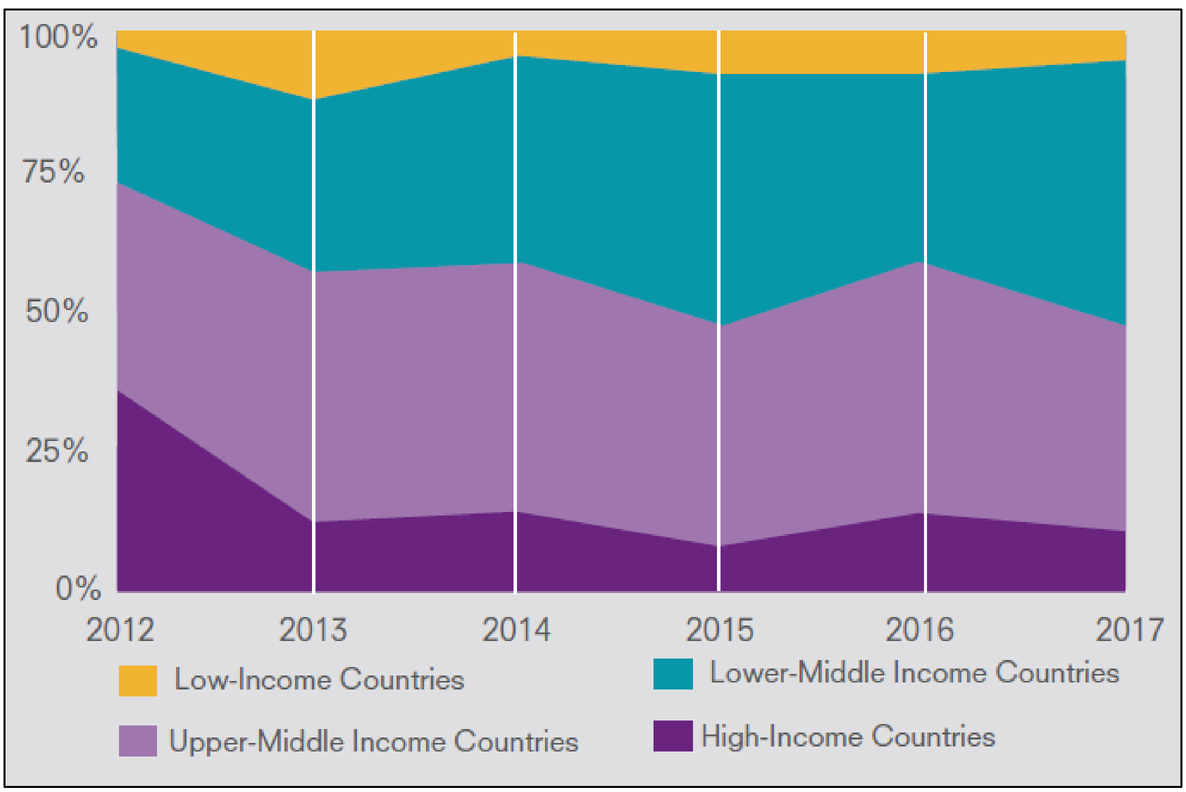
The issues facing fragile economies reinforce each other as the society is divided into two opposing groups where one group tends to believe that the state is captured by the other and therefore undermines the legitimacy of the state. Because of this lack of legitimacy, the state is unable to rely on members of society for compliance or community engagement resulting in the state failing. The lack of legitimacy and inadequate state functions results in lack of business confidence and employment opportunities. This leaves fragile economies exposed to shocks which the state cannot cushion and as such the frequency and severity of adverse shocks keep derailing attempts to escape from fragility (Collier, *et al.*, 2019).

The study by McKechnie, *et al.* (2018) states that fragile economies are dominated by the agriculture sector, as on average they have a higher proportion of employment within this sector.The process of moving labour out of lower-productivity agriculture and into high-productivities is crucial for structural change.

The current state of development finance in fragile economies has shown that although overseas development assistance (ODA) remains a critical source of financing for governments in fragile states, the desired level of economic growth remains unachieved. ODA is larger than foreign direct investment (FDI) in these states but not all ODA is intended for long-term development purposes as some is allocated for humanitarian needs. ODA accounts for 28 percent of financial flows in fragile states while FDI accounts for 22 percent (MENA-OECD, 2018). The track record of DFIs in fragile economies has received criticism as they have been accused of adopting risk-averse investment strategies and transactional approaches to investment deals, putting financial returns above development impact (Collier, *et al.*, 2021).

DFIs have invested mainly in well-off markets and safer sectors, thus sourcing very few new opportunities in fragile markets. As can be seen in Figure 2, DFI investment in low-income countries remain relatively low when compared with investment in upper-middle and lower-middle income countries. DFI investment is also higher in high-income countries as compared to low-income ones which is counterintuitive as development impact is required more in low-income countries.

Figure 2: DFI investment by country income



Source: Center for Global Development (2020)

Fragile economies are characterised by environments with a heightened exposure to investors' risk combined with a low government capacity to mitigate, manage or absorb these risks. As such, the business climates in these economies are not enabling. The

Doing Business Report (World Bank, 2019) which compares business regulation for domestic firms in 190 economies shows that fragile economies rank amongst the lowest countries in the world. Somalia, Yemen, South Sudan, the Democratic Republic of Congo and the Central African Republic rank among the lowest.

Table 1 shows that Libya is ranked 186 and scores poorly across all indicators, as since the 2014 relapse in conflict, the country has lacked basic regulations and institutional mechanisms that support the creation and operation of private firms. Iraq also ranks 171 and has performed poorly on indicators such as getting credit and trading across borders.

Table 1: 2019 Doing business ranking globally

Economy	Global rank	Starting a business	Dealing with construction permits	Getting electricity	Registering property	Getting credit	Protecting minority investors	Paying taxes	Trading across borders	Enforcing contract	Resolving insolvency
Jordan	104	106	139	62	72	134	125	95	74	108	150
West Bank and Gaza	116	171	157	85	84	22	161	107	54	123	168
Egypt, Arab Rep	120	109	68	96	125	60	72	159	171	160	101
Lebanon	142	146	170	124	105	124	140	113	150	135	151
Iraq	171	155	103	126	113	186	125	129	181	143	168
Libya	186	160	186	136	187	186	185	128	128	141	168

Source: MENA-OECD (2018) and World Bank (2019)

Fragility in some nations such as Iraq, can also be attributed to the impact of the United States invasion of the country in 2003, which resulted in the disbanding and dismantling of the Iraqi military and bureaucracy. This exacerbated economic stagnation, terrorism, criminality and crumbling infrastructure issues which are still present today (Flibbert, 2013).

The DBSA (2011) highlighted the challenges and risks of doing business in post-conflict and fragile states. The report investigated the trends of South African businesses in terms of venturing into post-conflict countries in Africa and their willingness to invest in these countries based on an assessment of opportunities versus risk. Many South African companies have developed entry strategies regarding venturing into other African countries and this includes investing into these countries via equity partnerships particularly in greenfield investments. Their strategies are also more in line with local business conditions in these countries.

The main sectors which South African businesses invest in are financial services, mining, construction, supplier services to the oil, gas and mobile telephones sectors amongst others. South African business with other African countries involves trade, the export of goods and services using local agencies, franchising and other non-investment business and the investment initiated when these countries entered eras of reform, economic liberalisation and privatisation (DBSA, 2011).

However, when investing in the rest of Africa, businesses in South Africa still face some challenges which include the high cost of doing business in other African countries, poor or non-existent infrastructure, regulatory and tax uncertainty, difficult and costly logistics, political risk, weak government institutions, corruption and currency fluctuations (DBSA, 2011). The high risk in these fragile states does however provide an opportunity for high rewards. High returns are in fact common in dysfunctional states as investing in them provides an early-to-market advantage which includes being able to negotiate highly preferential investment agreements with the government and to establish early brand presence and market dominance.

While entering these fragile markets is difficult and expensive, South African businesses have however established responsive risk mitigation strategies. The South African government has indirectly supported business by signing bilateral agreements covering trade, double taxation, investment protection and other areas (DBSA, 2011). Increased funding by development finance institutions can also draw more South African companies into development projects in the rest of Africa.

3. Methodology

To address the objectives of the study, the methodology followed embodies three approaches. Firstly, a systematic review of existing literature regarding fragile economies and the role and involvement of DFIs in these economies was conducted. Secondly, an analysis of the economic growth models such as the Solow Growth Model is implemented. Growth models have shown that an increase in savings and investment raises the capital stock and thus raises the full-employment national income of a country. Fragile states tend to have less physical and human capital accumulation and as such have limited growth potential. Thirdly, a case study was conducted to identify evidence of economic success in a fragile state, such as the development of the construction sector in Liberia. The choice of case study is based on the availability of economic data and conducted interviews.

4. Discussion of findings

4.1 Growth models and economic explanations for underdevelopment

Failed states are tense, deeply conflicted, dangerous and contested bitterly by warring factions and in most failed states, government troops battle armed revolts led by one or more rivals (Rotberg, 2003). These states have low levels of economic and social performance and this section discusses possible economic explanations for poverty traps by analysing growth models. The Solow Growth Model takes the following basic form:

$$\mathbf{Y\ (t) = F\ [K\ (t),\ L\ (t),\ A\ (t)]}$$

Where the economic growth of each country **Y(t)** is dependent on the capital accumulation **K(t)**, labour **L(t)** and technology **A(t)**. The basic rationale behind the Solow growth model with exogenous savings is that countries prosper due to factor accumulation and technical progress (Msier, 2010). The model shows that economic growth is a function of capital accumulation, labour and technology. Fragile states tend to have less physical and human capital accumulation and as such less technological progress which leads to limited growth. If two countries have access to identical production functions (functions of growth) by having the same rate of population growth and savings rate then the growth model assumes that they will converge to the same level of income assuming same innovation levels. As such in economic theory, a country that has a high savings rate and low population growth rate can increase its long term level of per capita income. Therefore fragile or post conflict states tend to have a low level of capital-labour ratio, thus operating further away from their own steady state values (Solow, 1956).

The Solow growth model does however have limitations as it cannot account for huge variations between countries. No country is identical to another, and the long run physical and human capital formation and fertility rate are endogenous variables (**K(t)** and **L(t)**) and technology (**A(t)**) is assumed to be exogenous as such countries will not reach the same steady states. The new growth theory does attempt to address these limitations by endogenizing technology in the growth theory. The assumption is that capital accumulation does foster technological change and the innovation can be spilled over to other countries or firms that will increase rates of returns (Msier, 2010).

Fragile states are therefore unable to take advantage of the spillover of technological innovation as they are unable to afford the technology or effectively make use of it. Since technology fosters growth in the new growth theory, fragile states remain limited in that regard. The underdevelopment of fragile economies characterised by inefficiencies and distortions hinders the adoptation of new technology and creates a poverty trap which is a self-reinforcing mechanism that results in poverty persisting (Azariadis & Stachurski, 2004).

It can be seen that accumulation in capital has a positive spillover to technological advancement in a country which then fosters economic growth. Therefore, Msier (2010) concluded that development policies in fragile economies should focus on investment into infrastructure for education and technological advancement, and thereby create economic growth. Initiatives such as free trade zones, regional integration with examples like the African Continental Free Trade Area and infant industry tariffs can go a long way to create ideal investment conditions in fragile states.

4.2 Fragility and inequality

The African Development Bank strategy for addressing fragility and building resilience in Africa highlighted horizontal inequalities, social exclusion and gender inequalities as key drivers of fragility that will need to be explicitly addressed in operational areas (AfDB, 2022). Social drivers of fragility can be pushed by the demand of individuals or groups in a society for inclusion and access to services, resources and opportunities that if not met lead to grievances, social tensions, rebelliousness and violence.

Gender inequality is another important driver of fragility, as conflict and fragility affect women, men, girls and boys differently. Women and children have been historically marginalised and conflict can further cause greater gender inequalities and increase the vulnerability of women and children. In their study, Koch (2008) highlighted how women and girls are often disproportionately affected by conflict as opposed to men and boys. In conflict affected states, girls' enrolment in primary and secondary school has been found to drop drastically as they are forced to stay home and assist with household duties. The enrolment of boys in school has in some states also been negatively affected as they are forced to drop-out of school and take part in the violence.

There is also inequality regarding healthcare in fragile states as wounded men compete with women who require health services such as giving birth. Women and girls are also often tasked with the burden of taking care of the wounded and the elderly in their households and the society at large which puts more strain to their own well-being.

In terms of employment, the evidence is mixed regarding how country level fragility and conflict affect women and men. It is however, evident that with men having been involved in the conflict, most households will be led by women, who will have the sole responsibility of providing financially for their households. In some literature, this has driven women into income generating long hours work in the informal sector such as farming (Quek, 2019; ILO, 2003; Nelson-Núñez, 2019). However, in some instances, women take up work in formal sectors which were left by men when taking part in the conflict (Koch, 2008).

The violence experienced by men and women is also different in fragile states as men are likely to be wounded and die in the fighting, but for women, gender-based violence increases substantially. In the absence of law and order, the trafficking of women and sexual exploitation increases drastically. Women are unable to arm and protect themselves and they also lack the mobility to flee the violence. Men may also suffer from gender-based violence but because of the stigma involved, the degree is unknown.

4.3 Escaping Fragility

4.3.1 Structural changes

The analysis of the economic growth theory models has shown that in order to foster growth in fragile states, capital and labour productivity are highly essential. Escaping the poverty trap and fragility will therefore involve social, political and economic stability within these states. That in turn, will cause structural changes and the efficient use of factors of production – shifting from lower to higher production activities. Wen (2016) provided an analysis of China’s rapid rise from a backward agrarian society to an industrial powerhouse in 35 years. The study showed how China’s shift from rural agriculture and informal services towards growth driven industrial sectors has resulted in its rapid economic growth.

The structural shift from low productivity to high productivity activities will results in underemployment and unproductive jobs being replaced by more productive jobs in the formal private sector. This will result in more jobs being created and the overall national income of the country increasing (Collier, *et al.*, 2021). Household income can increase and as such they can engage in spending on education, healthcare and savings which according to the Solow growth theory can foster growth.

The shift to industrialise an economy also involves the support of critical infrastructure such as roads, power generators and financial services. Fragile economies also have a limited export base when excluding natural resources and as such the firms' growth in these states is limited. The structural change will allow for the development of an export base for fragile economies which will increase firm-level growth and create trading channels with the rest of the world (Collier, *et al.*, 2021). With increased firms and an increased export base, governments in fragile states will have an opportunity to broaden their tax base and increase their tax revenue to enable them to provide basic public goods and services and improve infrastructure.

These structural changes are difficult to attain and require the government to create an enabling environment where the private sector can thrive (Noman & Stiglitz, 2015). The structural change process is driven largely by the private sector as firms have a competitive incentive to improve efficiencies and productivity. Without productivity growth and structural change, fragile economies have become stuck in low development equilibria with stagnating or falling growth rates.

4.3.2 Pioneering firms

The environment in fragile economies is not conducive for economic activity to take place, as such pioneering firms are essential as they take the first investment steps. Market pioneering is a commonly recognized form of corporate entrepreneurship where a firm is first to offer a distinctively new product, introduce a new process or enter and create a new market in fragile economies (Covin, *et al.*, 2000).

Pioneer firms are regarded as "first movers" in fragile economies and have the advantage of accessing unexploited natural resources, using low cost labour, provide basic services and have open entry to the market with little competition (Collier, *et al.*, 2019). By embarking in investment in uncharted fragile territory, pioneering firms will provide knowledge regarding the market structure and how to navigate it. Pioneering firms also provide jobs and training to the members of the society, support infrastructure and stimulate the local market.

The risk of pioneer firms going under is high as they have no prior knowledge of the local market conditions and as such will experience the necessary trial and error phases.The start-up cost of establishing these firms in these economies is also very high. The firms have to take into account developing non-existent infrastructure, navigating the regulatory environment, labour training and the possibility of failure due to unprofitability, conflict or political uncertainty (Collier, *et al.*, 2021).

A perfect example is the Southern Sudan Beverages Ltd which was a pioneering investment in South Sudan owed by SABMiller Group. The firm was established in 2009 and later went out of business in 2016 (Brewver, 2009). The pioneering firm which was at the time, the pride and joy of South Sudan was unable to survive the 20 month civil war in South Sudan which killed more than 10 000 people and further forced 2 million from their homes and left 4,6 million people with severe food insecurity (Jones, 2015).

The South Sudan brewery experienced shortages of fuel, raw materials and foreign currency. It lacked financing and domestic inputs as the banking sector in South Sudan was underdeveloped and the local agricultural and industrial development was weak. This resulted in majority of the inputs such as maize, malt, bottles and bottle tops being imported from neighbouring countries (Jones, 2015).

4.3.3 State building

The OECD (2008) has defined state building as the endogenous process to enhance capacity, institutions and legitimacy of the state driven by state-society relations and this involves the process of states functioning more effectively. The OECD has prioritised state building as the central objective of international partnership in fragile situations and in countries emerging from conflict, as such state building remains an important aspect in escaping fragility.

The process of state building involves reciprocal relations between a state that delivers services for its citizens and social and political groups that constructively engage with their state. The process also involves legitimizing the state by amongst other aspects, ensuring its ability to effectively and equitably provide services to its people. As such legitimacy is both a means and an end for successful state building. The development of administrative capacity within a state is also key for state building as a state cannot exist without administrative structures such as a functioning civil service and public financial management system. This also involves the ability of the state to raise funds through taxation which ensures that the state has a stake in its citizens' prosperity and the citizens can hold the state accountable for its performance or management of their taxes.

In the context of a fragile state, the establishment of a resilient state is of the utmost importance as a resilient state must be able to effectively deliver functions that match the expectations of its society. Managing the process of change and external and internal shocks associated with it remains important as failure to do so may generate violence and fragility. Failure of a state to be inclusive of all societal or political groups can also lead to the excluded groups challenging the state which can result in violence. In state building, it is therefore important for the state to engage and negotiate with all groups especially marginalized ones such as women and the disabled, to avoid undermining state building efforts in the long run (OECD, 2008).

4.4 The key role of DFIs in fragile economies

4.4.1 Supporting Pioneering firms

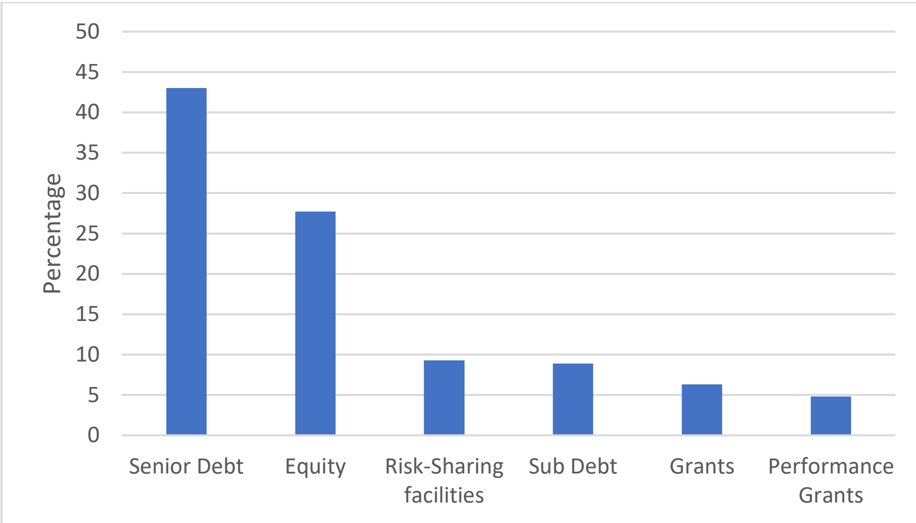
One role DFIs can play in fragile states, is by expanding their toolkit and providing support to pioneering firms. This is a mutually beneficial activity as in order for DFIs to identify sectors with high growth potential in fragile economies, supporting the entrance of pioneering firms in different sectors of a fragile economy will provide information regarding the risk and benefit within such sectors through experiences that they have faced. The generated information can reduce uncertainty and allow DFIs to have more information on which sector to invest in.

There are a number of channels through which DFIs can support pioneering firms and the private sector as a whole. One of the channels is through subsidy mechanisms. Traditionally, subsidies would be provided by the government, however, governments in fragile states lack the fiscal, administrative and financial capacity to do so. Therefore there is a role for DFIs to play by providing subsidies to pioneering firms as part of their financing role (IFC, 2017). DFIs can provide subsidies through blended financing mechanisms where they combine commercial financing terms with subsidies linked to specific costs, benefits and risks.

Blended concessional finance is a significant tool which DFIs can use to increase finance for private sector projects to help address Sustainable Development Goals and mobilise private capital (IFC, 2017). Between 2014-2016, DFIs had financed a total project value of more than USD 15 billion by various blended finance solutions.

Figure 3 shows the various financial products that were used by DFIs. Senior concessional loans and equity are more prevalent but there was also use of risk sharing facilities, subordinated loans and grants. The sectors that were most targeted by the concessional resources were infrastructure, banking and agriculture, while climate change was the most prevalent theme within these sectors.

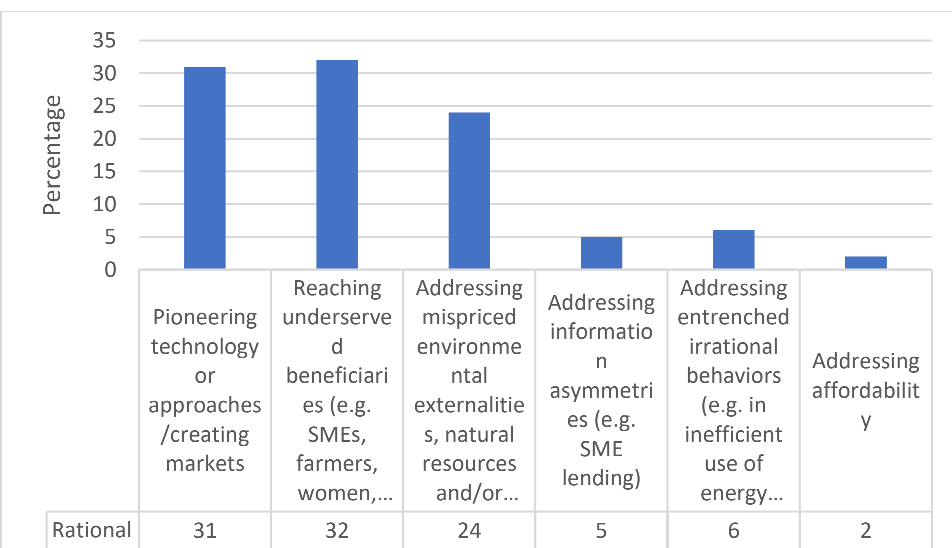
Figure 3: Concessional Commitments by Instrument, 2014-2016



Source: IFC (2017)

Figure 4 shows the rationale for using blended finance as identified by DFIs. Most projects were based on pioneering technology or creating markets and projects reaching underserved beneficiaries. DFIs can also play a role in actively seeking out such firms that are willing to participate in pioneering new markets in fragile states and support them through such subsidies.

Figure 4: Rationale for using blended finance, 2014-2016



Source: IFC (2017)

However the design of the subsidy allocation mechanism should support market creation and not give an advantage to the recipient that goes beyond the first mover/pioneer costs that it bears. DFIs also have a role to play in providing technical assistance and capacity building to firms in fragile economies through providing subsidized advisory services that support job training, market assessment and costly activities which pioneering firms need to undertake. DFIs can also go beyond firms and provide technical and capacity building support to governments in fragile states to help market creation which will in turn decrease the cost faced by firms entering these markets (see 4.4.5).

4.4.2 Patient, flexible and risk tolerant financing

Assuming local intermediaries exist, a recommended investment strategy by DFIs in fragile states would be to use local intermediary institutions to channel capital into these environments which can bring overhead costs down and leverage on the superior contextual knowledge of local intermediaries (CDC, 2019). The British International Investment (2019) DFI reported that based on previous experience in fragile states, a level of flexibility and diversification is required by DFIs when selecting which sectors to invest in. In some fragile economies, traditional ideas of which sector to invest in and which sectors not to invest in may be cast aside. DFI are expected to invest in traditional sectors such as infrastructure but in certain fragile economies, it may be more beneficial to invest in other emerging sectors.

Some emerging sectors can require more attention and face greater execution risk, therefore DFIs should play a role in identifying sectors which are below the government radar and which provide goods and services which have an unmet demand. The British International Investment has invested in commercial property and car hire firms in Sierra Leone. These are sectors which on the surface do not reflect a development agenda but based on local knowledge do actually facilitate development in the area (CDC, 2019).

DFIs also have a role to play in implementing more risk tolerant investment strategies in fragile economies through, for example, increasing equity participation in environments where early-stage equity markets are underdeveloped. The advantages of equity investment for DFIs are that they provide a degree of patience as there is less pressure for firms to generate immediate returns. They also allow for firms to prioritise long-term growth and provide a sense of stability during times of volatility (Carter, 2020). Equity investments also allow for DFIs to have better control of management decisions as in more fragile economies, a more hands-on approach is required.

4.4.3 Addressing inequalities

Conflict affects women and men differently, however, the reconstruction post-conflict provides an opportunity for transforming gender relations in a positive direction. DFIs have a role to play in addressing gender inequalities in fragile states, in order to provide inclusive growth and ensure the full participation of women within the economy. As part of their strategy to address fragility, the AfDB has developed a targeted program for empowerment of women to strengthen their roles as agents of change in the peace and state-building process (AfDB, 2022).

The AfDB has highlighted that the political, economic and legal empowerment of women is a key element that will suffuse their work in fragile economies. The gender strategy guides the engagement of the AfDB on the continent in terms of supporting gender equality through national development strategies and through their own operations. Their strategy involves encouraging the participation of women in peace and state-building at all levels and paying attention to the impact of gender-based violence faced by women during conflict situations. The AfDB follows the High Level Panel on Fragile States recommendations with regard to addressing fragility by supporting women’s livelihoods through entrepreneurship support and securing land tenure for women in building resilience (AfDB, 2022).

The AfDB gender strategy provides another role for DFIs in supporting health and education services in fragile states in order to ensure women and girls have non-discriminatory access to and participation in these services.

4.4.4 Supporting Trade Finance

The experience of the International Finance Corporation (IFC) in fragile states has led to the rise of other roles which DFIs can play in fragile economies. One such role is supporting trade financing in fragile states. The IFC has supported trade finance in fragile economies through the Global Trade Finance Program (GTFP) which extends and complements the capacity of banks to deliver trade financing by providing risk mitigation in new or challenging markets where trade lines may be constrained (IFC, 2019). Trade is essential for growth and is a key driver of integration and opportunities for local enterprises.

4.4.5 Providing advisory services to firms and government

Because of their experience, knowledge and expertise, DFIs have a role to play in terms of providing advisory services to governments and firms in fragile economies. This was evident in Sierra Leone where the AfDB provided critical strategic advisory services during the preparation of the country's third generation agenda for prosperity 2013-2018. The AfDB provided advice on gender empowerment, international competitiveness and green growth. The AfDB continues to play a leadership role in sectors such as transport and water in the country (AfDB, 2019).

The IFC has also played a role in providing advisory services in fragile states through the Creating Markets Advisory Window program and the Fragile and Conflict Situations Africa program. Both programs have provided advice in fragile economies to build capacity and strengthen the private sector. The Africa program in particular has provided advisory resources for investment teams that work on early-stage opportunities in fragile states in Africa (IFC, 2019). Both experiences have shown how DFIs can play a larger role in advising governments and firms in fragile states.

4.5 Types of investment required in fragile economies

Fragile economies need investment which creates jobs, spurs economic growth, generates tax revenues, bolsters infrastructure and creates a sense of hope for their people (Levy, 2016). The creation of decent jobs is key to reducing poverty and improving the standard of life in fragile states. DFIs should focus on replacing informal unstable jobs with formal stable jobs or rather improve the quality of informal jobs (Carter & Petr Sedlacek, 2019).

Collier, *et al.* (2021) has emphasized the need for catalytic investments in fragile states as they affect multiple nodes of an economic network. These types of investments have a direct and indirect multiplier effect on the entire economy and result in knowledge transfers, capacity building, reduction in the price of intermediate inputs and economies of specialisation. DFIs also have to promote investments that are conflict sensitive as the inflow of resources in resource-scarce fragile environments will cause locals to fight amongst each other for control of these resources which may cause more harm than good. These conflict sensitive investment strategies involve sector and project-specific analysis and accounting for the evolving nature of the conflict cycles.

Before the establishment of the fragile and conflict situations Africa program, the IFC had implemented the Conflict Affected States in Africa program which provided a conflict sensitive approach based on the assessment of the political risks associated with an investment. The program also analysed the fragility induced impacts that an investment could provoke and accordingly adjusted for it (IFC, 2013).

4.6 Infrastructure development in fragile economies

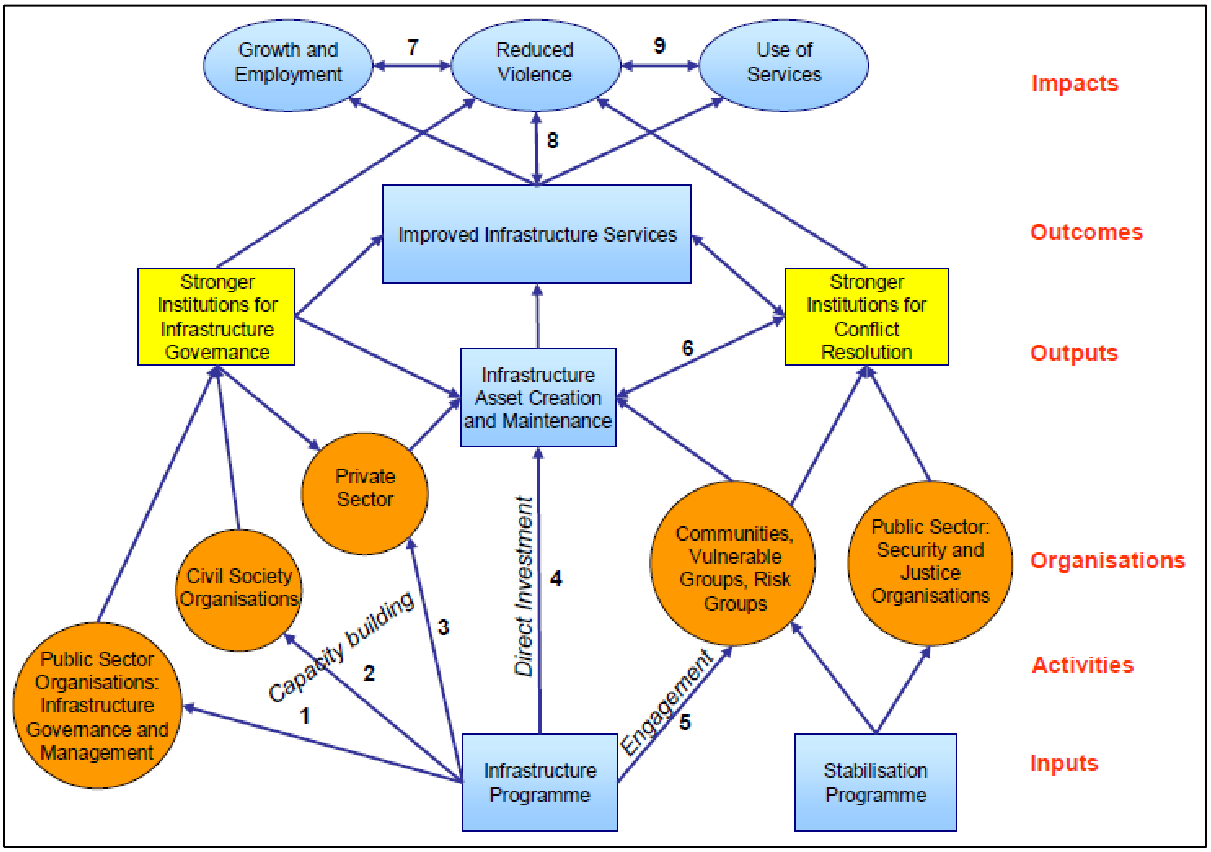
The economic returns to infrastructure in fragile economies are likely to be very high, with investment in energy and transport infrastructure likely to present the highest immediate economic returns. In their study, Jones and Howarth (2012) identified the main causal relationships by which infrastructure programmes may contribute to economic growth, improved access to services and poverty reduction. They also investigated the relationship between infrastructure and the process of stabilisation, peace-building and state-building.

The study highlighted a number of roles which infrastructure plays in breaking the cycle of fragility in these states, such as the role it plays in enabling collaboration over planning and implementation of infrastructure, which can result in restoration of confidence in collective action and wider cooperation in fragile states, which can go a long way towards fostering peaceful and effective means to accommodate divergent interests. The use of community based models for infrastructure development are ideal strategies to foster peace and state building by restoring a culture of togetherness.

Investment in infrastructure in fragile states also contributes to the creation of a more business friendly environment that will foster economic activity where the private sector can thrive. Jobs will also be created through the construction of the infrastructure and its maintenance. Human security can also be improved through investment in security and justice infrastructure such as courts and police stations. Investment in communication infrastructure can also allow for improved internal connectivity and give an opportunity for marginalised communities to be part of mainstream social and economic activity.

Figure 5 gives an indication of how infrastructure programmes can potentially have a developmental impact in fragile economies. It is evident that infrastructure programmes have a role to play in capacity building for public sector organisations, civil organisations and the private sector. This in turn builds stronger institutions for infrastructure governance and improves infrastructure asset creation and maintenance. Infrastructure programmes also involve engagement with community members in terms of job creation and consultation which can further foster development of stronger institutions for conflict resolution. With the development of stronger institutions and investment in infrastructure comes improved infrastructure services which can foster economic growth and improve job opportunities while also reducing violence and promoting the use of basic services.

Figure 5: Relationships for infrastructure programmes in fragile economies



Source: Jones and Howarth (2012)

The AfDB approaches fragility from a multi-dimensional risk perspective and believes that persistent inequalities between different societal groups, structural exclusion and lack of inclusive growth are critical issues that need to be addressed in order to address fragility (Kaplan & Teufel, 2016). In the AfDB perspective, weak transport connectivity reinforces social divisions in fragile communities and results in the marginalisation of a number of people which results in domestic instability.

This emphasizes the importance of investment into transport infrastructure in fragile states destroyed during times of violent conflict. Investment into road infrastructure can create social cohesion by improving connectivity and integration of states. Greater social cohesion has been known to reduce the possibility of conflict and foster stability, growth and governance (Kaplan & Teufel, 2016). Improved road infrastructure also provides an easier and cheaper way of travel and communication which improves the effectiveness of state institutions across distance.

The investment in road infrastructure especially in rural regions also creates a foundation for inclusive development which is not only concentrated in urban areas. It also allows the government to provide services like education, healthcare, security and others, equally across all environments within fragile economies which can foster balanced growth and reduce inequalities, exclusions and marginalization. Improved road infrastructure also improves connectivity with neighboring countries which results in the creation of larger markets and the ease of exporting and importing of goods and services.

4.7 Challenges faced by DFIs in fragile economies

Challenges facing DFIs in their efforts to invest in fragile economies include macroeconomic elements such as the political and economic instability in fragile states which create difficult environments for DFIs and the private sector to thrive. Other elements include the infrastructure deficiencies.

The weak human capital in fragile states also poses a challenge to DFIs in terms of investing in them as it limits the supply of investment opportunities as there is a limited work force available. The weak physical and mental health of individuals in fragile states may affect the supply of productive labour. Due to acts of violence and conflict, individuals in fragile states are exposed to traumas on a scale not known to the rest of the world, which will likely cause psychological and mental health issues.

As such, even when DFIs provide support for pioneering firms in such states in order to create job opportunities, these firms may not reach their full productive capacity. Human development and training may be required to increase the overall cost of investment. Other challenges such as lack of state capacity and lack of information on local markets will also increase the overall costs of operating in fragile economies.

Another challenge that DFIs face when investing in fragile states is the rigid investment requirements that have been placed by DFI shareholders which the DFIs should meet. These investment requirements can include investing at commercial terms, losses and risk aversion and maintaining environmental, social and governance standards (Collier, *et al.*, 2021). These requirements are standard and therefore unsuitable for different environments which presents a challenge and as such limits the DFIs' ability to make development impact in fragile economies. Investing in fragile economies does have higher risks, inevitable financial losses and returns may not materialise until after many years. As stated before, DFIs investing in fragile states requires patience, which may not be part of the investment requirements made by shareholders.

Besides limits posed by shareholders, DFIs themselves can have internal barriers towards investing in fragile economies (Collier, *et al.*, 2021). These include a corporate structure which prioritizes successful deal making, which will encourage risk aversion behaviour which will steer DFIs into investing in high income countries, where returns are most likely guaranteed. This is fear of failure behaviour which will limit the DFI's reach into fragile economies, which deserve greater assistance than already developed or developing countries and will have a larger development impact on the states that require it more.

This risk aversion behaviour can also be motivated by the reputational risk associated with investing in fragile economies as environmental, social and governance standards may not be met and as such create a bad reputation for the DFIs. Standards should be adjusted to account for the scope of work required in these environments and should not be compared with standards in place in more developed countries.

4.8 Policy considerations for improving development finance in fragile economies

Having examined some of the challenges facing DFIs in investing in fragile economies, it is clear that some of these challenges can be addressed by changes in policies within

DFIs that will allow them to play a more meaningful role in fragile economies. The first would be a change in the corporate culture of DFIs which fosters risk aversion and deal making. In fragile economies, success should be redefined away from deal making and more towards job creation. DFIs’ staff members should be rewarded also for the productive jobs created from projects and not only on the basis of deals and transactions made.

Fragile economies carry more risk and as such high risk tolerant policies are required from DFIs and room for failure should be provided, as there will be knowledge gained from such experiences that will provide more insight into the market structures that can be used for better project preparation in the future. It does remain unclear how much risk is enough, as too much risk and recklessness can also be a problem and proper risk mitigation techniques will therefore be required. One such technique would be for DFIs to establish a working relationship with governments and civil society groups within these fragile economies in order to gain more insight from those within the country, in order to better scope the potential for investment in certain sectors.

Working relationships should also be established amongst multiple DFIs themselves in multiple forms. One such form can be through the co-financing of projects in fragile economies in order to share risk and develop more expertise. The collaboration amongst DFIs can also go further into information sharing on experiences in different fragile states.

The Commission for State Fragility, Growth and Development from the International Growth Centre of the London School of Economics held a meeting with multiple DFIs across the world. The participating DFIs agreed to cooperate in rolling out pilot interventions in a number of fragile states. The participating DFIs including the AfDB agreed to enhance collective dialogue amongst development agencies to leverage on diverse skills and improve complementarity, manage financial and non-financial risks and work together on reforms to strengthen business environments in fragile states (AfDB, 2020).

5. Case study of successful investments in fragile states

5.1 Construction Sector in Liberia[1]

Fragility in Liberia is characterized by poor governance and nearly fifteen years of brutal conflict, which have made the country one of the poorest in the world, as ordinary citizens feel ostracized from the political and decision-making process. Fragility is also manifested in the failure of the state to deliver basic services to citizens. Liberia has one of the worst public sectors in West Africa, with poor quality of policy delivery and public investment management, according to the AfDB's 2020 Country Resilience Fragility Assessment.

Therefore, citizens, mainly youth, are more likely to express their displeasure toward government through constant demonstrations. Moreover, access to opportunities is determined by background, urban-rural divide, social classes, ethnolinguistic identities and education leading to various forms of exclusion. Social mobility for marginalized groups is low due to multidimensional inequalities, livelihood constraints, low human development and emerging forms of intolerance.

Liberia identified infrastructure reconstruction and capacity building as being key to the country's recovery, economic growth and poverty reduction after almost 14 years of civil war which undermined its human development and devasted the country's construction sector. In 2012, it was reported by the Ministry of Public Works that only about 970 construction firms operated in the country, which were mostly shell companies set up for contract farming and subcontracting, and as such were unable to execute public work (McKechnie, *et al.*, 2018). The Doing Business Report ranked Liberia 179 out of 189 countries in 2016, as the conditions for doing business in the country were very severe (World Bank, 2016).

The underdevelopment of the local construction sector in Liberia was attributed to the lack of a business conducive environment in the state which was a result of a number of factors. The local construction sector also lacked management and engineering capacity

[1] Data sourced from Interview with key informant from Liberia

which means the local contractors are too incapacitated to manage large projects. There was also a lack of financing from the financial sector which in itself was underdeveloped and as such contractors were unable to source credit to fund projects. The weather conditions in Liberia also restricted the progress of construction projects as heavy rainfalls are experienced throughout the year.

Other challenges in the sector include the lack of equipment within the construction sector and when importing equipment into the country, logistic constraints were experienced due to the lack of road and port infrastructure. Road infrastructure is very important not only to facilitate trade but also to connect individuals across different parts of the country. Such investment into road infrastructure was required in Liberia but because of its post conflict nature, which results in high risk, investors were unlikely to participate.

In order to address the issues of lack of capacity in the construction sector and the lack of road infrastructure in the state, the Liberian government engaged the foreign private sector in highway construction and maintenance through Output and Performance based Road Contracts (OPRC). This agreement was that a contractor would be awarded a 10 year contract to produce a detailed design and rehabilitate a highway and provide maintenance throughout the period of the contract. The infrastructure will be the property of the government however, the contractor will be paid throughout the period of the contract (McKechnie, *et al.*, 2018).

The OPRC approach is preferred in fragile states as because of its long term nature, risk is reduced as the government is more likely to make payments to the contractor and not default. It is also ideal for the contractor to maintain the infrastructure and not the government as the contractor would have better knowledge and capacity. The project for Liberia was for the Red Light – Gate 15 – Gbarnga – Ganta – Guinea Border and Cotton Tree To Buchanan roads (Gericke, *et al.*, 2014).

The World Bank administered Liberia Reconstruction Trust Fund provided funding for the OPRC project with a USD 108,9 million grant combined with a International Development Association credit of USD 67,7 million and additional government funding of USD 72,8 million (World Bank, 2017). The World Bank further extended an additional credit of USD 90 million to scale up the project by including an additional road and to finance road safety improvements.

Once Liberia put in place the first OPRC, two Chinese contractors were successful and were responsible for the construction and the maintenance of the infrastructure for the 10-year duration. One of the Chinese contractors employed and trained 900 Liberians and 54 Chinese for the construction of the roads as well as for equipment operation. On the construction site, mobile plant operators, surveyors and general workers were Liberian with only a small amount of workers being foreigners (McKechnie, *et al.*, 2018).

This case study is an illustration of how a proactive government leadership, supported by multilateral development banks was critical in bringing private participation into fragile economies. With this entire experience, the World Bank, being a partner and financier, has gained invaluable knowledge with regard to how OPRC can be incorporated and used to foster infrastructure investment in fragile states. This knowledge can be shared with other development finance institutions to establish a possible investment path into fragile states.

Beyond the construction sector, the AfDB through the Government of Liberia, has invested in transport and energy infrastructure in the country, and indirectly, through multi-country assistance benefitting the other three Mano River Union countries (Sierra Leone, Guinea and Ivory Coast). As of August 2022, the AfDB's investment portfolio for Liberia comprised 18 ongoing and recently approved operations, with a total financial commitment of USD 478 million. The active portfolio spreads across five sectors and is heavily invested in infrastructure, predominantly roads (USD 262 million) and energy (USD 105 million). The transport sector accounts for the largest share of the portfolio (56 percent), followed by energy (22 percent), agriculture and rural development (12 percent), and multi-sectors (4 percent).

In the energy domain, the AfDB is co-sponsoring investments, cooperating with other development partners, aimed at providing modern, adequate, and affordable energy systems in Liberia. Core investments include renewable energy, power transmission and distribution, and rural electrification.

6. DBSA policy framework for situations of fragility

The DBSA applies a responsible approach to investing in fragile economies that is informed by the DBSA's role as a DFI in implementing its development position. The DBSA works together with its development partners on the continent in supporting situations of fragility, conflict, and violence transition to stability through the provision of development and financing support. When appraising investment opportunities in fragile economies the DBSA looks at measurement indicators such as economic, environmental, political, security and societal indicators (DBSA, 2021).

In fragile states, the DBSA promotes investment that supports resilience and recovery, while promoting sustainable returns and demonstrating development impact. The DBSA catalyzes project preparation by acting as market catalysts to build sustainable project pipelines to support the transition out of fragility. To de-risk interventions in fragile states, the DBSA identifies and implements risk management measures to support these development and financing interventions. The DBSA project screening, early review and investment due diligence culminate in an appraisal report to address project risk and unlock structured financing solutions (DBSA, 2021).

As a responsible investor, the DBSA undertakes an enhanced environmental, social and governance due diligence to identify, manage and mitigate the intersection of fragility, project risk and resilience. The DBSA also commits to ensure that projects and programmes consider inclusivity and gender mainstreaming in situations of fragility to address gender-based violence (DBSA, 2021). The DBSA adopts a context specific and client centric approach to interventions in fragile situations that contribute to stability and peacebuilding. The bank delivers development and financing solutions across the investment value chain including:

- Project Planning: Undertaking conflict analysis including assessment of the institutional capacity of the state, macroeconomic conditions, security situation and any linkages between political and economic systems. Develop fragile country strategies providing granular market intelligence identifying the nature of risks within the fragility context, the geographic pockets of fragility and sources of resilience, identify the key local protagonists and possible partners. Market assessments to apply a fragility lens to operations design, country, and regional programming.
- Project preparation: The Bank commits to playing an active role in multiple investment and development initiatives identified through engagements with local institutions, stakeholders, and public institutions. The Bank supports the design of projects which are responsive to the fragile context and recognizes that extensive resources are likely to be committed to supporting policy development, building private sector and/or government capacity, and the identification of viable sponsors.
- Project Financing: The Bank undertakes an enhanced due diligence to address context specific fragility conditions particular to each fragility situation. This may include conflict analysis, institutional, macroeconomic, and security assessments, integrity due diligence, and contextual ESG assessments. The Bank applies flexible approaches responsive to the fragile situation, to support sustainable infrastructure investment solutions. This includes the use of suitable de-risking structuring approaches, including use of guarantees and blended finances approach, among others.
- Project execution: Play an active role in project implementation: Undertaking active project oversight by managing complex environmental and social governance issues, recruit strong lead investors, support regulatory reforms, follow up local presence ensure the active participation of capable implementing organizations, and support capacity building where needed.
- Portfolio management: Oversight of portfolio. Interface with National Government. Arm’s length relationship at implementation level ring fenced portfolio management of transactions in fragile contexts. Regular reporting to Board.

The DBSA can make an impact in high-risk countries by offering support to pioneering firms, providing patient, flexible and risk tolerant financing, addressing gender inequalities, supporting trade finance, providing advisory services to firms and governments, and fostering infrastructure development in fragile economies. The research showed different lessons that were learnt with regard to the key roles the DBSA can play in fragile economies. Such as the flexible and innovative investment into commercial property and car hire firms in Sierra Leone by British International Investment, which on the surface does not reflect a development agenda but based on local knowledge, does actually facilitate development in the area.

Another lesson learnt was from the AfDB which played a role in providing critical strategic advisory services to Sierra Leone during the preparation of the country's third generation agenda for prosperity 2013-2018. The AfDB provided advice on gender empowerment, international competitiveness, green growth and continues to play a leadership role in sectors such as transport and water in the country. The Liberia case study also shows lessons learnt with regard to infrastructure investment and development in fragile economies, which has improved the Liberian construction sector and created development impact.

The research further analyzed the type of investment required in fragile economies and policy considerations that should be implemented to allow DBSA to improve development financing in fragile economies. The findings from this study can support the DBSA Investment Committee when reviewing the DBSA fragile states policy framework or when considering transactions.

7. Conclusion

The first objective of this research was to investigate and establish an approach for DFIs to navigate fragile environments and which roles should they play in fragile economies. The second objective was to determine how DFIs can identify and participate in investment sectors with the most growth potential within these fragile economies. The research first analysed fragility and the measures required to escape it from an economical, political and social point of view.The study also investigated key challenges facing DFIs in fragile economies and recommended key policy considerations for improving development finance in these economies.

The findings from the study highlight that measures required to escape fragility include structural changes, pioneering firms and state building. The study also highlights the roles DFIs can play in fragile states such as supporting pioneering firms, providing patient, flexible and risk tolerant financing and addressing gender inequalities. Other added roles include supporting trade finance, providing advisory services to firms and governments and fostering infrastructure development.

The study has also found that in order to navigate fragile environments, a recommended investment strategy by DFIs would be to use local intermediary institutions to channel capital into these environments. This can bring overhead costs down and leverage on the superior contextual knowledge of local intermediaries. The challenges facing DFIs in fragile economies include macroeconomic elements, infrastructure deficiencies and rigid investment requirements that have been placed by DFI shareholders which the DFIs should meet. DFIs themselves can have internal barriers towards investing in fragile economies. These include a corporate structure which prioritizes successful deal making and encourages risk aversion. These challenges can be addressed by changes in policies within DFIs that will allow them to play a more meaningful role in fragile economies.

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