Financing the SDGs

PUBLIC INTEREST

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The world of development finance has not, until recently, intersected significantly with the world of private finance. This is because the working assumption has been that countries develop by mobilising public resources to deliver development objectives, while the private sector invests in growth. Other than delivering public goods (like law and order) and merit goods and services (like education and sanitation), the job of the government was seen as fostering an enabling economic environment in which the private sector could do its job.

This assumption, always dubious, obviously does not hold at the present juncture. The efficient markets hypothesis, the bedrock on which this division of labour was founded, is dead. The assumption that savings would find their way to the most attractive investments is not valid. And the notion that the binding constraint to development is the lack of capital is now untrue. The world saves at least $20 trillion annually. Reliable estimates indicate that financing the delivery of the SDGs and climate change measures is estimated at a maximum of $7 trillion. So adequacy of financing is no longer the problem. The question is why it is not being allocated to investments in the SDGs, which would maximise global growth. There are around $40 trillion of global savings locked in long-term investment platforms like pension funds which earn no more than 2 per cent, while returns to investments in infrastructure in emerging economies could yield at least three times that return even with full hedging. This is a massive allocation failure.

The mispricing of risk is at the heart of this allocation failure. Risk models applied to developing and emerging economies take the level of GDP to be the proxy for systemic risk (the risk posed by poor governance, incomplete contracts, vulnerability to crises and shocks). Since developing countries definitionally score poorly on this count, this makes long-term private sector investment very expensive, if at all available.

These models do not take into account, that the activities of governments and their public interventions are risk reducing. Better human development and environmental outcomes reduce systemic risk. Delivering public safety, public sanitation, a healthy populace, preventing pandemics, a better justice system, an effective disaster prevention and recovery system, all reduce systemic risk. But these risk reductions are not factored into the risk calculus. The fact that India has effectively dealt with pandemics, eradicated polio, and has in place a disaster management system that is the envy of many, has not entered risk models simply because there is no place for them.

How to change this is the big development finance question of our times. At the operational level, this requires an active effort to reduce the weight attached to level of GDP in assessing risk at the country, sector and project levels. This requires defining and delivering alternative risk reduction indicators that overlap with those used to measure SDG progress, by using these to reduce the weight allocated to the level of GDP. This also requires exploring ways in which initiatives and innovations in the global financial architecture can be harnessed to make this re-alllocation of finance happen.

The multilateral development banks do undertake de-risking. But what they offer is concessional finance — such transfers risk from the private to the public balance sheet, by transferring risk premia from the project or sector level, to the national or international taxpayer. This does not *reduce* risk except as an occasional externality. It is valuable work, but it does not address the main problem as I see it, which is to actually reduce the risk premium of an investment by reducing the weight of the level of GDP variable that is used in the risk calculus.

Securing adequate finance for the SDGs therefore involves creating the conditions for *non-concessional* private sector finance to be attracted to the SDGs. The most immediate way that this can be done is by demonstrating that activities undertaken to achieve the SDGs and climate goals is collectively risk-reducing, and this is something that risk models need to recognise and incorporate. This is a conversation for which the time is ripe given the low rates of return that long term finance is securing, compared to what it could by investing in developing and emerging economies.

These are global conversations about *systemic* agendas. The United Nations development system, the IMF, and the World Bank must leave their comfort zones to engage in these conversations with the private sector, to change the contours and design of the global financial system going forward, not just ways of doing business, or reforming institutions. Finance Ministries, the G-7 and the G20 need to see that SDG achievement is their core business, as it about maximizing global growth

The end result is quantifiable: a major indicator would be a reduction in the risk weight through a reduction in the level of GDP weight in risk calculation algorithms. Bur for this to happen the private sector, national governments and the multilateral system need to have a completely different conversation on how the needed systemic changes can be identified and executed, to the benefit of all. In New York, I am encouraged to see the secretary general recognising this challenge and seeking to work with partners to address it. A complex task, with high returns, for which the time has come.

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