The background of the cover features a close-up, high-contrast photograph of an American flag. The red and white stripes are prominent, with the blue field containing white stars visible in the upper left corner. The flag is draped over a light-colored, heavily textured surface that resembles stone or concrete, with the texture becoming more pronounced as it moves away from the flag.

SEPTEMBER 2019

Strategic Directions for the United States International Development Finance Corporation (DFC)

Supporting Development and National Security

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A Report of the CSIS PROJECT ON PROSPERITY AND DEVELOPMENT

CSIS | CENTER FOR STRATEGIC &
INTERNATIONAL STUDIES

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Acknowledgments

The authors would first like to thank their CSIS colleagues Erol Yayboke, Greg Poling, Carmen Gallego, MacKenzie Hammond, Shannon McKeown, and Sarah Baumunk for their research, writing, and editing efforts. Special thanks to the CSIS Dracopoulos iDeas Lab for their input on the report layout and graphics and to CSIS interns Elena Bernardi, Steven Weirich, Matthieu Lebreton, and Anastasia Zausner for their dedication to quality research support on this project.

During the first half of 2019, CSIS interviewed 80 stakeholders in off-the-record meetings in three countries (Tunisia, Philippines, and Guatemala) as well as 15 experts from DFIs and other development agencies. We would like to thank them for their insights. We also would like to thank the 30 experts who participated in the two roundtables held in Washington, D.C., in April and May 2019 for sharing their views and offering creative solutions for the DFC. Finally, 8 experts reviewed this report while 10 country stakeholders provided inputs to the country case studies (Annex A). We are grateful for your constructive feedback that has been drawn from decades of development finance experience.

This report is made possible by the Smith Richardson Foundation's generous support to CSIS.

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Executive Summary

The United States International Development Finance Corporation (DFC), which starts operations in October 2019, will modernize the U.S. development finance architecture. The DFC will merge the staff, assets, and liabilities of the Overseas Private Investment Corporation (OPIC) and the U.S. Agency for International Development's (USAID) Development Credit Authority (DCA). It will seek to catalyze vitally needed private sector investments in low- and lower-middle-income countries via new development finance tools such as local currency loans, first loss guarantees, loan guarantees (including in local currency), and equity investments.

However, the DFC is not designed to be simply another development finance institution—in addition to a greater proposed focus on development impact, it is an agency also embedded in the U.S. foreign policy and national security architecture. This report offers concrete and independent ideas on how the DFC can better support U.S. national security interests but also examines its limitations. Within this context, the three key U.S. national security challenges that CSIS highlights include a) China's rising influence in the developing world, b) actions the United States and others can do to further mitigate violent extremism, and c) addressing the root causes of migration.

U.S. Foreign Policy Challenges and the DFC

The creation of the DFC serves a multifaceted approach and is a first step toward enhancing U.S. foreign policy objectives, revamping U.S. development finance tools, and countering China's state-sponsored development model. One of the critical issues that the new DFC will need to address is “how, where, and with whom will the new DFC help achieve foreign policy, development, and national security goals?”

The challenges of job generation, migration, and violent extremism can be partially offset by creating new economic opportunities for citizens in developing countries. The DFC can help address this specific series of national security and foreign policy challenges by enjoying a set of development finance instruments that improve upon the ones currently at the United States' disposal. The DFC can and should support these objectives, but it is also important to recognize that the DFC's role in these areas will be limited. Fostering economic growth and private sector development through the deployment of development finance is only one part of the response for countering violent extremism, China's rise, or migration flows. The complexity of these issues will require concerted

action from the security, diplomatic, and development communities. Addressing these challenges will also entail soliciting greater collaboration among development finance institutions (DFIs) and development institutions with host country governments. The primary responsibility for development falls on the countries themselves; however, multilateral and bilateral institutions play an important role in supporting these efforts, especially in countries where the institutional and governance structures are weak.

The DFC will only be able to help address these challenges in an indirect way by helping build strong private sectors abroad. It can do so by using its new financial toolbox more creatively, pursuing more innovative approaches to development, and partnering with other development players.

AN ALTERNATIVE APPROACH TO THE CHINESE DEVELOPMENT MODEL

The DFC was set up, in part, as a response to China's aggressive use of finance to build influence in the developing world. China has recognized the economic potential of sub-Saharan Africa, Latin America, and Asia and has built strong economic relationships within these regions to facilitate greater engagement. China has since become an affordable supplier of poor-quality infrastructure for many Asian countries, a position some would argue has harmful consequences for developing countries. However, the United States cannot compete with China in the developing world on a dollar-for-dollar basis. China provides too much money through its government institutions and state-owned enterprises and is able and willing to undercut its short-term financial gains for long-term diplomatic and strategic influence.

The DFC has an opportunity to offer a different development model than China's. The DFC should focus on the comparative advantages of U.S. investment in infrastructure projects that are developmentally sound and make financial sense without displacing the private sector and focus on supporting the creation of market-based economies by utilizing its enhanced development finance toolbox. The DFC will be well-positioned to implement deals and share expertise through partnerships with a cadre of well-respected DFIs from around the world—this is something China cannot offer either. Moreover, China does not significantly support small and medium-sized enterprises (SMEs) or entrepreneurship abroad. This leaves a critical gap that the DFC is well-positioned to fill, and that plays to the United States' competitive advantage.

By highlighting transparency in procurement processes, free-market economic principles, technology and knowledge transfers, high standards, and a willingness to invest in SMEs, the DFC could use its projects to show countries that quality prevails over cheap and quick investments, such as those offered by China.

COUNTERING VIOLENT EXTREMISM AND PROVIDING STABILITY

A second major development challenge that impacts U.S. national security is the threat of violent extremism. Criminal groups and radical extremist movements take advantage of people when they are poor, aggrieved, and have no meaningful economic opportunities. These movements can threaten the international order as well as the stability of national governments. These groups are increasingly aided and fueled by easy access to technology, which allows them to organize, finance their operations, and arm themselves.

While joblessness, economic exclusion, and youth idleness are contributors to the likelihood of youth joining extremist groups, other factors also play a role. Weak state and institutional capacity, political disenfranchisement, and upbringings plagued by war and gang violence play an equal, if not greater, role in the propensity for youth to join gangs and terrorist organizations. In other words, terrorism and violent extremism are not caused solely by poverty and joblessness, but these challenges make it easier for radicals to recruit foot soldiers in fragile contexts.

DFIs and the multilateral development banks (MDBs) have little experience in countering violent extremism because this has not been part of their traditional modus operandi. However, this is a new policy area where MDBs, DFIs, and other donors are being asked to play a bigger role. These are precisely the places we see market failures and therefore need a helping hand, but where even the current risk-averse international DFIs shy away from. There is an increased political push for international development institutions to operate in low-income countries and, in particular, fragile and conflict-affected states (FCS) to help develop the private sector and attract higher amounts of private financing. The DFC and other development institutions should also seek to devise new financing tools and mechanisms to help counter fragility, conflict, and violence by supporting the work of peacebuilders and diplomats. An FCS unit in the DFC could work with other DFIs, MDBs, and U.S. agencies to:

- **Experiment and Build Knowledge:** Understand what works and what doesn't, generate knowledge about the root causes of violent extremism, and identify some of the most successful interventions so far. It will require greater collaboration among development partners to learn about different interventions and avoid overlap and waste.
- **Provide Financing:** The DFC should focus its efforts on projects that have the capacity to generate employment (for example, by targeting specific sectors) and that will foster greater social cohesion (for example, by increasing financial inclusion). The DFC could work with other DFIs to support pioneer firms and complementary investments in fragile states and to create new financing instruments specifically for engaging youth in fragile contexts.
- **Foster Greater Social Inclusion:** By supporting women's economic participation, sectors that have high employment potential and financial inclusion, the DFC can help build stronger economies and a more effective and long-lasting peace and security process in a country.

ADDRESSING THE ROOT CAUSES OF MIGRATION

A third development challenge that impacts U.S. national security derived from a lack of economic opportunities at home is increased irregular migration. Countries with large youth populations that lack meaningful work opportunities have a greater risk of emigration. The primary goal for all stakeholders working in countries with large migration rates is to provide the necessary economic, social, and political conditions to prevent people from wanting to emigrate in the first place. This will be a long-run endeavor that will require the collaboration of a range of donors and host country governments. The impact that the DFC will have on deterring migration will be limited and indirect, either through job creation or developing infrastructure that can support

long-run economic growth. Other challenges such as persistent violence and lack of security, gang warfare, human and drug trafficking, and other “push factors” for migration will require different interventions.

For the DFC to better support countries’ development efforts, it should approach the Northern Triangle (El Salvador, Guatemala, and Honduras) or other regions with large migratory populations with the help of other DFIs, development agencies, and U.S. partners. As it plans investments in these countries, it needs to target regions that are underdeveloped and underfunded and focus on sectors that can create jobs or better services, so people are enticed to stay in their countries of origin. The sectors will vary from country to country, but agro-processing and SME development are two candidates that were highlighted in our case studies. One approach to address migration is for the DFC to invest in the development of secondary cities so that citizens have better opportunities than the ones offered by congested and overstretched capital cities. Secondary cities could provide thousands of new jobs for workers of all skill levels if the DFC invests in supporting urban infrastructure. People migrate to cities looking for better services: transport, health and education, sanitation, open spaces, entertainment, dining, and security. In this regard, investing in smart cities to supply modern urban services would be a unique value-add that U.S. technology can provide and would be a significant upgrade for city functions and citizen experiences.

Recommendations

The United States offers intangible qualities, which need to be better communicated and marketed. Transparency in procurement processes, free-market economic principles, technology and knowledge transfers, increased environmental safeguards, debt sustainability assessments, quality infrastructure standards, and a willingness to invest in SMEs are some of the distinct advantages of the U.S. development finance approach. U.S. companies competing for contracts might have higher costs in the short term, but through lower lifecycle costs and the benefits of U.S. technical training, it becomes clear the United States is the better partner in the long term. These are unique features that the DFC needs to highlight. Making this strong case is critical for the DFC and other U.S. agencies and allies to start winning more deals. To maximize the potential of the DFC, CSIS offers a series of recommendations to ensure its foreign policy goals and development mandate are met:

- 1. Manage Expectations and Set a Medium-Term Goal:** First and foremost, the DFC will need to manage expectations. The DFC must be upfront that the first two years will be a transition period and it will probably ramp up investments in year three using its full toolbox—especially in the more difficult geographical contexts. The DFC can begin to realistically pursue targets (such as \$8 billion per year in new commitments) at the five- to six-year mark, after the DFC has more firmly settled on the appropriate levels of risk and reward for projects. It is also important for the success of the DFC to set a medium-term goal on what the agency wants to accomplish 10 years from now. Setting a numerical goal in terms of levels of commitment and development impact can drive the agency to become more focused. In pursuing this medium-term goal, the DFC will need to ramp up its work in more challenging countries—that is, the poorest and most fragile

states. This will come with risk, and stakeholders will have to be more tolerant of failure. CSIS believes that the DFC should not overextend itself by targeting many countries and sectors. Particularly for fragile contexts, it should take a more focused approach by selecting a few countries and targeting specific sectors that could be transformational for the country. Moreover, as the DFC reaches its seventh year in 2026, Congress should consider reauthorizing the institution for another 10 years. In year seven, Congress should also consider indexing the DFC's credit exposure of \$60 billion to take inflation into account and remain competitive with other modern DFIs.

2. **Adopt a “Team America” Approach – Strategic and Coordinated:** The United States is often perceived to “do development” in a piecemeal approach with various agencies supporting different needs with sparse coordination. The launch of the new DFC is a chance for U.S. development agencies to follow a more coordinated and holistic approach to private sector development abroad. The DFC has an opportunity to lead better interagency coordination by adopting a “Team America” approach in-country that brings together the expertise of different agencies. This commitment must come from the top of the agencies, with a clear message from Washington headquarters and the U.S. ambassador on the ground trickling down to staff of each agency working in-country.
3. **Create Greater Awareness of the DFC and U.S. Development Finance Tools:** Moving forward, the DFC should outline and advertise the development finance instruments it has to offer, given that its new mandate has significantly expanded the toolkit it can use to include equity investments, first loss guarantees, and local currency financing. Many U.S. government officials do not understand the role of DFIs in general and what the DFC can do. It is critical that DFC officials in Washington create a communication strategy explaining the function and potential of the DFC to the foreign policy community as well as other U.S. agencies. A system of staff secondments between the Department of State, USAID, MCC, and the DFC would also contribute to a better understanding of U.S. development finance tools and foreign policy goals and could increase interagency collaboration. More targeted training for the U.S. Foreign Service and USAID staff could also be strong complements to the DFC's communication strategy.
4. **Staff the Agency Appropriately:** As the DFC starts building up its portfolio, it will be important that Congress appropriate the necessary budgetary resources and staff so that it can carry out its enhanced mandate. The DFC must also recognize the value of having representatives on the ground in geostrategic regions. Companies and institutions consider face-to-face interactions to be valuable and necessary for business dealings. To win deals, relationships are critical, and relationships built over the phone or during a few business trips per year cannot be cultivated to the same degree as regular, face-to-face interactions. The DFC should aim to have more local presence on the ground, but it does not need to create unnecessary bureaucracy such as setting up a local office in each country where it operates.
5. **Collaborate with Allied DFIs:** A strategic collaboration on financing, technical assistance, processes, and development impact with allied DFIs would also be

instrumental in minimizing inefficiency, duplication, and wastefulness. Some examples of areas where donors could undertake joint work include:

- **Financing:** Setting up joint project preparation facilities; co-financing (syndication) or co-guaranteeing projects or investing in equity funds
- **Technical Assistance:** Delivering joint training in project preparation and procurement processes to government employees of developing countries and assisting government agencies in putting together a pipeline of bankable projects
- **Processes:** Conducting joint due diligence on projects, applying same project selection process and documentation; applying same environmental, social, and governance standards in projects; and adopting the standards of the Osaka G20 principles on quality infrastructure to attract similar DFIs, nations, and private investors who are willing to share risk on sustainable, quality development projects and build a coalition against China's investment standards
- **Development Impact:** Harmonizing definitions and indicators on "development impact," and applying same impact measurement tools

6. Use the New Development Finance Toolbox Strategically: There is set of countries in need of sophisticated development finance products and approaches. The DFC can work with other U.S. government (USG) agencies and use its enhanced toolbox to achieve significant development impact by:

- Using technical assistance to untap local savings and create robust capital markets
- Scaling up the use of DCA guarantees for underserved sectors
- Cultivating SMEs and entrepreneurship through anchor investments and first loss guarantees
- Using its equity authority—investing in equity funds and setting up new enterprise funds
- Using its grant capacity to increase the developmental impact or improve the commercial sustainability of a pipeline of bankable projects

7. Invest in Sectors with High Development Impact: When it comes to specific sectors, the DFC will have to evaluate the needs in each country it intends to invest in, the U.S. comparative advantages vis-à-vis other development partners; and the likely development impact of its investments. The DFC should not be spread too thin: it needs to focus on a narrow set of sectors where it can make investments to have greater impact. Some of the strategic sectors identified through the research process where the DFC could make an impact are in infrastructure development, agribusiness, and financial inclusion/financial sector development. Projects supporting urban services and smart cities that demonstrate U.S. quality and values would also greatly increase U.S. visibility.

Opportunities and Limitations

While the DFC has expanded tools and capabilities that will assist in meeting U.S. foreign policy goals, the United States must remember that there are limitations on what it can accomplish. Some of the expectations about what the DFC can do are unrealistic and need

to be highlighted. This is just one agency in the development finance ecosystem and thus will not be able to solve all development challenges on its own.

First, the DFC is not the equivalent to China's Belt and Road Initiative (BRI). What China has to offer is a very distinct financing model—often export-based and politically-driven—compared to the Western approach. But this could change if the United States works with like-minded partners to sway China to adopt Western standards and approaches and/or builds the capacity of recipient nations to negotiate better deals with the Chinese. Second, the DFC will not be able to double its commitments in the first years. It will be more prudent, at least in the first two years, for the DFC to plan investments carefully to strike the right balance between risk and returns of its interventions and to clearly communicate and manage expectations that the DFC deliberately expects a higher failure rate and why. Finally, the DFC should not be thought of as a substitute for traditional U.S. foreign aid but rather complement foreign assistance efforts. As countries move up in the development ladder, they will need less foreign aid and will be able to rely more on their own domestic resources (such as taxes and savings) and private investments to finance their development challenges. However, grants will still be needed in countries with inadequate government capacity and weak economic fundamentals to tackle humanitarian, environmental, and health emergencies.

The launch of the DFC provides a renewed opportunity for the United States to further its private sector development efforts abroad and mobilize significant private investments through a development model that is based on market principles, transparent processes, and debt sustainability. The DFC will have to operate in spaces that have traditionally not been its predecessor's core business and thus will be pushed to cross boundaries. Yet, this also provides a chance for the DFC to innovate, take on more risk, and leverage the work that other U.S. agencies and development partners are carrying out to build robust private sectors abroad.

Project Background

The Project on Prosperity and Development (PPD) at CSIS partnered with the Smith Richardson Foundation (SRF) in January 2019 on a research project examining the strategic directions for the new U.S. development finance institution, the United States International Development Finance Corporation (DFC). This report provides an independent, medium-term assessment for the DFC as it begins operations in October 2019. The recommendations produced in this report lay out a vision for the next 5 to 10 years that are acceptable to both sides of the U.S. political spectrum—Republicans and Democrats alike.

CSIS was one of the Better Utilization of Investment Leading to Development (BUILD) Act’s key architects. Over the past seven years, CSIS participated in several Congressional hearings and produced numerous research materials in support of the BUILD Act and development finance modernization (see Annex C for a listing of related research). Starting in 2011, CSIS has run a very active program to strengthen and enable development finance in the United States. Some examples of our written work include “Sharing Risk in a World of Dangers and Opportunities” (2011), “Development Finance Institutions Come of Age” (2016), and, most recently, “The BUILD Act Has Passed: What’s Next?” (October 2018). PPD Director Daniel F. Runde testified twice regarding the BUILD Act.

The DFC is not designed to be simply another development finance institution—in addition to a greater proposed focus on development impact, it is an agency also embedded in the U.S. foreign policy and national security architecture. This report offers concrete and independent ideas on how the DFC can better support U.S. national security interests but also examines its limitations. Within this context, the three key U.S. national security challenges that CSIS highlights include a) China’s rising influence in the developing world, b) actions the United States and others can do to further mitigate violent extremism, and c) addressing the root causes of migration. The main questions we sought to answer through this project are:

How the DFC can support U.S. foreign policy, development, and national security goals via a series of key strategic questions:

- *Where and how can the DFC counter the rise of China as a development player?*
- *Where and how can the DFC address instability and counter the rise of violent extremism?*
- *Where and how can the DFC address the root causes of migration?*

CSIS approached the project through a two-part method:

- a bottom-up approach, consisting of country case studies to better understand local stakeholders' views on the DFC; complemented by
- a top-down approach, consisting of the expertise of Washington-based policymakers and high-level staff from allied development finance institutions.

During the first half of 2019, CSIS met key stakeholders (U.S. embassy teams, local business leaders, country government officials, and multilateral development agencies) in three developing countries to gather views on the ground on how the DFC could be most effective in meeting their country's needs. CSIS focused on three very different but strategically important regions of the world: Central America, North Africa, and Southeast Asia. Within these regions, we chose the Philippines, Tunisia, and Guatemala as country case studies due to a large U.S. influence or presence and their representation of the three key U.S. national security challenges of China's rise, violent extremism, and youth migration. Over 25 experts were consulted in each country. These case studies have been published as separate papers.

CSIS also convened two private roundtable discussions in Washington, D.C., with nearly 30 stakeholders from various academic institutions, multilateral development banks, private sector entities, and allied development agencies. Finally, 15 interviews were conducted to better understand how the DFC can fit into a changing development landscape, work more collaboratively with other partners, focus on the proper sectors, and achieve its development impact and financial goals.

Introduction

The use of economic, diplomatic, and developmental tools in bolstering the private sector is crucial to solving the problems America now faces. Whether it is countering China, confronting the challenges of migration, thwarting terrorism, or other global security issues, governments and their traditional foreign aid mechanisms are not properly equipped to solve these problems without leveraging the private sector. Although the United States remains the world's largest foreign aid provider (spending roughly \$34 billion each year, according to the OECD/DAC), progress on global challenges will not be made without the help of U.S. allies and other partners who seek to spur free-market economic principles abroad.

In this regard, bilateral as well as multilateral development finance institutions (DFIs) play a catalytic role in economic growth by helping crowd in private capital to developing countries. DFIs are government-backed institutions that invest in private sector projects in developing countries (Box 1). Supported by numerous studies tying job growth to private investment, DFIs have grown in importance over the last 15 years and will continue to lead foreign assistance norms over the next decade. In addition, China has emerged as a peer competitor to the United States. Through the Asian Infrastructure Investment Bank, the New Development Bank, as well as the Chinese Ex-Im Bank and other government-owned institutions, China is flooding the world with capital and loans.

The Overseas Private Investment Corporation (OPIC), the United States' DFI, was created in 1971 to catalyze private investments abroad. OPIC has helped promote investment in 160 countries, primarily through political risk insurance and loan guarantees as well as limited support for private equity funds and loans, with a liability cap of \$29 billion.¹ Despite OPIC's success operating at no net cost to taxpayers for decades, OPIC was limited in both the financing tools it could deploy and its development reach. The summation of these forces and the rise of the great power competition led the current U.S. administration to conclude that a stronger, more capable DFI with a renewed emphasis on avoiding market distortions and consolidation of tools from across the USG was needed. A broad coalition came together in 2017 and 2018 to pass the Better Utilization of Investment Leading to Development (BUILD) Act. The BUILD Act provides several enhancements to OPIC by establishing a new entity called the United States International Development Finance Corporation (DFC).

1. "FAQs on BUILD Act Implementation," OPIC, <https://www.opic.gov/build-act/faqs-build-act-implementation>.

The DFC will seek to catalyze vitally needed private sector investments in low- and lower-middle-income countries via new development finance tools such as local currency loans, first loss guarantees, loan guarantees (including in local currency), and equity investments. The DFC can help solidify the work of different U.S. agencies, non-governmental organizations (NGOs), and other companies that work on fostering the private sector abroad. Through its enhanced toolbox, the DFC has an opportunity to collaborate more effectively with U.S. allies such as Canada, Japan, the United Kingdom, and the Netherlands.

As the DFC begins its operations in October 2019, an independent and constructive analysis of its future is needed. This report lays out a strategic framework for the new DFC for the next 5 to 10 years that should be acceptable to both sides of the political aisle. CSIS aims to inform the DFC's strategy going forward, including ways to deploy its development finance tools and to determine its geographical footprint to support U.S. national security interests.

The BUILD Act is the most significant foreign assistance legislation in 15 years, and it took both a tremendous amount of political capital and a unique alignment of political interests for its enactment. As with any start-up, the next 12 to 24 months are critical for the new agency that is now saddled with some unrealistic expectations. The DFC has enormous potential yet some practical limitations. This report will help untangle what is possible and address how the DFC can and cannot contribute to the most pressing national security, foreign policy, and development challenges.

BOX 1: WHAT IS A DFI?

Development Finance Institutions (DFIs) are government-backed institutions that invest in private sector projects in developing countries to help support development goals. Contrary to Official Development Assistance (ODA), which comes in the form of grants and concessional lending, DFIs invest in commercially sustainable projects providing direct loans, guarantees, political risk insurance, and equity.² DFIs are guided by three criteria of success: project sustainability (i.e., the project is financially viable in the long run), catalytic effect (i.e., providing development outcomes), and additionality (i.e., the unique benefit they bring since the private investment would not have happened if DFIs were not involved).

While ODA is still the dominant form of development funding at \$146 billion, DFIs have become a central part of the development finance architecture. For 2017, CSIS's analysis showed a total commitment of \$87 billion in non-sovereign, private sector development financing by the world's 30 largest DFIs.³ Main bilateral DFIs in terms of commitments include the United States' Overseas Private Investment Corporation (OPIC) (\$3.3 billion in 2018 commitments), the Netherlands' FMO (\$2.9 billion in 2018 commitments), France's PROPARCO (\$1.7 billion in 2018 commitments), and the United Kingdom's CDC Group (\$1.3 billion in 2018 commitments); the biggest multilateral DFI is the International Finance Corporation (IFC), which committed \$11.6 billion in 2018—mainly in the financial services and power sector.⁴ Power and financial services (OPIC), agribusiness, water and food and energy (FMO), infrastructure and financial services (CDC), and water and electricity (PROPARCO) are some of the main sectors that DFIs invest in.

2. Daniel F. Runde, Conor M. Savoy, Dirk Willem te Velde, Paddy Carter, and Alberto Lemma, *Development Finance Institutions Come of Age* (Washington, DC: CSIS, 2016), <https://www.csis.org/analysis/development-finance-institutions-come-age>.

3. Daniel F. Runde and Aaron N. Milner, *Development Finance Institutions: Plateaued Growth, Increasing Need* (Washington, DC: CSIS, 2019), <https://www.csis.org/analysis/development-finance-institutions-plateaued-growth-increasing-need>.

4. "FMO Annual Report 2018," The Netherlands Development Finance Company (FMO), 2018, <https://annual-report.fmo.nl/2018/>; IFC, *Redefining Development Finance: Financials 2018* (Washington, DC: IFC, 2018), <https://www.ifc.org/wps/wcm/connect/23886a98-aa76-4dee-90b9-bb45571cd108/IFC-AR18-Volume-2-Financials.pdf?MOD=AJPERES&CVID=mon07L5>; "IFC Financial Highlights," IFC, https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/annual-report/financials/ar18-fin-highlights; CDC Group, *CDC Group plc Annual Accounts 2018* (London, England: CDC Group, 2018), https://assets.cdcgroup.com/wp-content/uploads/2019/07/29142812/22365_CDC_AnnualAccounts_2018_190723.pdf; "2018 Annual Results- PROPARCO's commitments top the EUR 1.5bn mark," PROPARCO, April 10, 2019, <https://www.proparco.fr/en/2018-annual-results-proparcos-commitments-top-eur-15bn-mark>; OPIC, *2018 Annual Report* (Washington, DC: OPIC, 2018), <https://www.opic.gov/sites/default/files/files/OPIC-AnnualReport2018.pdf>.

1 | The DFC: A Foreign Policy Development Bank

The challenges of job generation, migration, and violent extremism can be partially offset by creating new economic opportunities for citizens in developing countries. The DFC can help address this specific series of national security and foreign policy challenges by enjoying a set of development finance instruments that improve upon the ones currently at the United States' disposal. The creation of the DFC serves a multifaceted approach and is a first step toward enhancing U.S. foreign policy objectives, revamping U.S. development finance tools, and countering China's state-sponsored development model. One of the critical issues that the new DFC will need to address is "how, where, and with whom will the new DFC help achieve foreign policy, development, and national security goals?" CSIS considers that there are three U.S. national security challenges that development agencies and the DFC will need to address: i) providing a viable alternative to China's development model, ii) countering violent extremism through job creation, and iii) addressing the root causes of migration via private sector development.

Key U.S. Foreign Policy Challenges

OFFERING AN ALTERNATIVE APPROACH TO THE CHINESE DEVELOPMENT MODEL

The DFC was set up, in part, as a response to China's aggressive use of finance to build influence in the developing world. China has recognized the economic potential of sub-Saharan Africa, Latin America, and Asia and has built strong economic relationships within these regions to facilitate greater engagement. It has set up its own multilateral lending institutions, the New Development Bank (NDB) and the Asian Infrastructure Investment Bank (AIIB), to spread and increase its influence across the developing world. China's Belt and Road Initiative (BRI) aims to connect Chinese trade with more than 70 countries and will include between \$1 trillion and \$4 trillion in transportation and other infrastructure investments.⁵

China has since become an affordable supplier of poor-quality infrastructure for many Asian countries, a position some would argue has harmful consequences for developing

5. Zack Cooper et al., *China's Maritime Silk Road: Strategic and Economic Implications for the Indo-Pacific Region* (Washington, DC: CSIS, 2018), https://csis-prod.s3.amazonaws.com/s3fs-public/publication/180404_Szechenyi_ChinaMaritimeSilkRoad.pdf.

countries. For example, signees on deals with China are required to accept China-based dispute resolution; in one case, Sri Lanka handed over a controlling equity stake and 99-year lease of Hambantota port to Beijing because of insufficient debt repayments. China is also invested in the technology race through the spread of Internet access and development of 5G technology, which poses international security risks (Box 2). The United States needs to look at Asia not only through an economic opportunity and security lens; it must also understand that China is a full-fledged soft power competitor throughout the region and elsewhere.

However, the United States cannot compete with China in the developing world on a dollar-for-dollar basis. China provides too much money through its government institutions and state-owned enterprises and is able and willing to undercut its short-term financial gains for long-term diplomatic and strategic influence. The significant project completion speed discrepancy—where it may take seven years for the United States and other development players to complete a project and China will finish the job in two or three—also puts the West at a serious disadvantage. Similarly, China’s notoriously opaque contracts and “no questions asked” development policy remain significant barriers the United States must overcome when vying for deals in countries with poor procurement policies and ubiquitous corruption.

The DFC has an opportunity to offer a different development model than China’s. The DFC should focus on U.S. comparative advantages: invest in infrastructure projects that are developmentally sound, make financial sense without displacing the private sector, and focus on supporting the creation of market-based economies by utilizing its enhanced finance toolbox. The DFC will be well-positioned to implement deals and share expertise through partnerships with a cadre of well-respected DFIs from around the world—this is something China cannot offer. Moreover, China does not significantly support small and medium-sized enterprises (SMEs) or entrepreneurship abroad. This leaves a critical gap that the DFC is well-positioned to fill, and that plays to the United States’ competitive advantage.

BOX 2: THE RACE FOR 5G TECHNOLOGY

5G is the most recent development in the advancement of wireless telecommunication and mobile networks technologies. The new technology will be able to deploy and transfer data at unprecedented speeds with far better security and reliance.^{6,7} It will also enable the connection, interaction, and transfer of data between billions of devices of any kind (the internet of things) for the future digital economy.⁸ Emerging industries, markets, and advanced technologies that comprise the fast-approaching “internet economy” (smart cities, autonomous vehicles, etc.) will require the expanded capabilities of 5G networks.⁹

Huawei, a Chinese multinational technology company founded in 1987, is now the world’s largest supplier of telecommunications network equipment and the second largest producer of smartphones. Huawei is not, however, without its controversies. The company has been heavily subsidized by the Chinese government (receiving \$222 million in government grants in 2018) to acquire market dominance and an intelligence advantage. Furthermore, its leaders have connections to the People’s Liberation Army and Chinese intelligence services, and the Chinese government possesses the ability to control the company’s operational directions and future.¹⁰ Therefore, fears over the Chinese government forcing Huawei to hand over data gathered from its devices in use abroad have sparked international controversy vis-à-vis the tech giant’s intentions.¹¹ Huawei operates in more than 170 countries and regions and has provided about 70 percent of Africa’s 4G network infrastructure.^{12,13}

U.S. intelligence agencies allege that China will use Huawei equipment in the United States as a “backdoor” for espionage and data collection purposes to benefit the Chinese state and harm U.S. interests.¹⁴ Thus, President Trump initially announced an outright ban of all dealings with Huawei and the United States. But at this year’s G20 Summit, President Trump declared that U.S. tech companies such as Google, Qualcomm, and Intel

6. James A. Lewis, *How 5G Will Shape Innovation and Security: A Primer* (Washington, DC: CSIS, 2018), <https://www.csis.org/analysis/how-5g-will-shape-innovation-and-security>.

7. Ivana Kottasová, “5G is revolutionary but will anybody pay for it?” CNN Business, February 27, 2019, <https://www.cnn.com/2019/02/26/tech/5g-mwc-mobile-world-congress/index.html>.

8. Dan Littmann et al., *5G: The chance to lead for a decade* (Chicago, IL: Deloitte, 2018), <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/technology-media-telecommunications/us-tmt-5g-deployment-imperative.pdf>.

9. Congressional Research Service, *Fifth-Generation (5G) Telecommunications Technologies: Issues for Congress* (Washington, DC: Congressional Research Service, 2019), <https://fas.org/sgp/crs/misc/R45485.pdf>.

10. Lindsay Maizland and Andrew Chatzky, “Huawei: China’s Controversial Tech Giant,” Council on Foreign Relations, June 12, 2019, <https://www.cfr.org/background/huawei-chinas-controversial-tech-giant>.

11. Ibid.

12. “Corporate Introduction,” Huawei, <https://www.huawei.com/us/about-huawei/corporate-information>.

13. Amy Mackinnon, “For Africa, Chinese-Built Internet Is Better Than No Internet at All,” *Foreign Policy*, March 19, 2019, <https://foreignpolicy.com/2019/03/19/for-africa-chinese-built-internet-is-better-than-no-internet-at-all/>.

14. Jonathan Weber, “Explainer: What is China’s Huawei Technologies and why is it controversial?,” Reuters, December 6, 2018, <https://www.reuters.com/article/us-usa-china-huawei-explainer/explainer-what-is-chinas-huawei-technologies-and-why-is-it-controversial-idUSKBN105172>.

will be permitted to supply goods to Huawei so long as they do not include 5G patents and more advanced technology.¹⁵ The ban itself has not had particularly large international implications or reverberations yet. Some U.S. allies agree that using Huawei equipment is risky, but this is not stopping them from taking advantage of Huawei's cost, speed, and reliability over other telecommunications hardware manufacturers. Most countries have not posited a stance geared towards banning the company, likely for fear of economic backlash, such as with Australia's ban in 2018.¹⁶ On the extreme end, countries such as Vietnam and Japan that see China as a threat to their sovereignty have banned the entrance of Huawei into their 5G systems.¹⁷

In the case of developing countries, they are simply waiting to see how the dispute will move forward and what the effects of bans on Huawei telecom infrastructure may be. Nevertheless, countries that are willing to trade secure infrastructure for more affordable telecom prices are also more than willing to have Huawei as their primary telecom infrastructure provider. The Philippines, for example, has pushed back against the White House's efforts to curtail Huawei's expansion by allowing the company to supply its next generation 5G networks.¹⁸ And, as mentioned before, Africa's Internet and telecommunications needs of today are being met largely by Huawei.

Given the state of play, the DFC will need to be prepared to support 5G infrastructure abroad in case a viable alternative to Huawei's 5G network infrastructure is found. A U.S. or Western firm that could compete with Huawei would be a game changer for the development finance and foreign policy spheres. It is critical that the DFC be ready to support a U.S. company (or ally) that offers an alternative approach to Huawei.

COUNTERING VIOLENT EXTREMISM

A second major development challenge that impacts U.S. national security is the threat of violent extremism. Criminal groups and radical extremist movements take advantage of people when they are poor, aggrieved, and have no meaningful economic opportunities. These movements can threaten the international order as well as the stability of national governments. These groups are increasingly aided and fueled by easy access to technology, which allows them to organize, finance their operations, and arm themselves.

Many countries lack strong economic and governance structures that could offer alternative pathways for youth. Currently, large segments of youth in the developing world are unemployed (more than 64 million). Youth are three times more likely to be

15. William Alan Reinsch, "And the Beat(ing) Goes On," CSIS, July 2, 2019, <https://www.csis.org/analysis/and-beating-goes>.

16. Bennett Murray, "Vietnam Doesn't Trust Huawei An Inch," *Foreign Policy*, May 9, 2019, <https://foreignpolicy.com/2019/05/09/vietnam-doesnt-trust-huawei-an-inch/>.

17. Ibid.

18. Niharika Mandhana, "In Global Tech Battle, a Balky U.S. Ally Chooses China," *Wall Street Journal*, July 15, 2019, https://www.wsj.com/articles/in-global-tech-battle-the-philippines-has-chosen-sides-not-the-u-s-11563205891?mod=hp_lead_pos10.

unemployed than adults and more than 1 in 5 youths are disengaged (not in school, education, or training).¹⁹ This demographic shift has many security and economic implications. Youth who are neither employed nor in school are more likely to disengage from the labor market and civil society and more susceptible to recruitment by gangs, as child soldiers, or even terrorist networks. Studies have found that youth bulges are connected to a higher risk of political violence. Moreover, unemployment, especially of young males, and violence are related, although the link is not straightforward.²⁰

The world's most prosperous countries are aging, but most of the developing world will continue to have large youth populations over the next 30 years. By 2030, the UN predicts that there will be 3.3 billion people under the age of 25 (versus 1 billion elderly).²¹ Children and youth will need both quality education and meaningful economic opportunities to be productive and active members of their societies. Unfortunately, a lack of meaningful employment opportunities for citizens and disengagement from society and governance structures may result in increased transnational criminal activity, terrorism, drug dealing, human trafficking, and political radicalization—all issues that have significant security implications for the United States.

Given the looming demographic changes in regions such as sub-Saharan Africa and the Middle East and North Africa (MENA), countries will need to target growing youth populations and create meaningful opportunities for work to avoid potential social or political instability stemming from unemployment. By supporting greater stability overseas through job creation and economic opportunity, the DFC can help advance U.S. security interests.

ADDRESSING THE ROOT CAUSES OF MIGRATION

A third development challenge that derives from a lack of economic opportunities at home is increased irregular migration. Countries with large youth populations that lack meaningful work opportunities have a greater risk of emigration. In many parts of Africa and the Northern Triangle of Central America (El Salvador, Guatemala, and Honduras), people face a life-altering choice to stay or go due to conflict, instability, and slow economic growth. Countries are also experiencing increased emigration of highly skilled and unskilled workers, who choose to leave to pursue more economically rewarding opportunities abroad. It is important that these countries enact policies that will retain their populations and provide suitable job opportunities for citizens of every education level.

Most of the people attempting to cross the U.S.-Mexico border come from the Northern Triangle because these countries lack economic opportunities or suffer from high rates of gang violence and criminal activity. Though there may be short-term increases in migration as countries develop, these root causes of migration are less prevalent when countries reach the \$8,000-\$10,000 per capita threshold.²² In this regard, developing

19. International Labor Organization (ILO). 2019. Youth Employment. <https://www.ilo.org/global/topics/youth-employment/lang-en/index.htm>.

20. Henrik Urdal, "A Clash of Generations? Youth Bulges and Political Violence," *International Studies Quarterly* 50, no. 3 (September 2006): 608-629; Christopher Cramer, *Unemployment and Participation in Violence* (Washington, D.C.: World Bank, 2010), <https://openknowledge.worldbank.org/handle/10986/9247>.

21. UN DESA Population Division, *World Population Prospects 2017* (New York, NY: United Nations, 2017), <https://population.un.org/wpp/>.

22. Lawrence MacDonald, "Migration's Inevitability and Labor Mobility – Michael Clemens," Center for Global

the private sector is important in creating stable economies and providing meaningful economic opportunities for citizens to help reach this benchmark. As many as 9 out of 10 jobs in developing countries are created by the private sector.²³

The United States and its allies can help accelerate development in countries where migration is a serious issue by targeting strategic regions or sectors. Addressing the root causes of migration will require a medium-term approach to economic development; there are no easy shortcuts. This will require a concerted effort from governments, NGOs, and the private sectors in these countries.

Development, May 22, 2014, <https://www.cgdev.org/blog/migrations-inevitability-and-labor-mobility-michael-clemens>.

23. IFC, *IFC Jobs Study: Assessing Private Sector Contributions to Job Creation and Poverty Reduction* (Washington, DC: World Bank Group, 2013), https://www.ifc.org/wps/wcm/connect/0fe6e2804e2c0a8f8d3bad7a9dd66321/IFC_FULL+JOB+STUDY+REPORT_JAN2013_FINAL.pdf?MOD=AJPERES.

2 | The DFC's Mandate and New Capabilities

The DFC was conceived as an institution to support U.S. foreign policy, development, and national security interests and offer an alternative to authoritarian development models. The DFC will retain much of what OPIC was capable of and sought to accomplish, but it will possess new instruments and an updated mandate. The DFC is expected to work more closely with U.S. development agencies and leverage the strengths of the U.S. Agency for International Development (USAID), the Millennium Challenge Corporation (MCC), the Department of State, and the Department of Commerce (see Box 3 and Annex B).

The DFC will seek to crowd in private capital in developing countries (that is, make investments in places where private capital is not readily available) and complement U.S. development and foreign policy goals. Like OPIC, the DFC's mission is to “provide businesses with the tools to manage the risks associated with foreign direct investment (FDI), foster economic development in emerging market countries, and advance U.S. foreign policy and national security priorities.”²⁴ Unlike most other DFIs (with the possible exception of Japan), the DFC is an agency meant to be embedded in the U.S. foreign policy and national security architecture.

Main Organizational Changes

The DFC will combine the functions, personnel, assets, and liabilities of OPIC, USAID's Development Credit Authority (DCA)²⁵, and USAID's existing legacy credit portfolio (the Urban Environment Program, other non-DCA guarantee programs, and other direct loan programs), merging their financing responsibilities to create an up-to-date, consolidated federal agency. In October 2019, approximately 270 OPIC and 40 DCA staff members will transfer to the DFC. OPIC's projects with 90 different country partners will become the bulk of the DFC's portfolio.

24. “OPIC mobilizes private capital to help solve critical development challenges,” OPIC, <https://www.opic.gov/who-we-are/overview>.

25. DCA offers partial-credit guarantees to financial institutions (known as loan portfolio guarantees) to generate additional lending in underserved markets. These guarantees cover no more than 50 percent of the loan amount and are offered in both as a foreign currency and local currency guarantee (although, in the latter, DCA commits to a \$ denominated exposure cap). DCA has provided \$5.5 billion in credit to 80 different countries between 1998-2018. Source: “Development Credit Authority: Putting Local Wealth to Work,” USAID, 2018, https://www.usaid.gov/sites/default/files/documents/1865/DCA%20One-Pager%20for%20Financial%20Partners_FY2015_Final.pdf.

The DFC will begin operations with a liability limit of \$60 billion, which is more than double OPIC's \$29 billion maximum. The DFC will have a seven-year reauthorization—a huge boost to stability and coordination over OPIC's annual reauthorizations from Congress since 2007. Furthermore, the BUILD Act ensures that investments from U.S. small businesses will receive preferential consideration and will compose at least 50 percent of all U.S. investors' projects supported by the DFC.²⁶ The DFC will also be required to consider the impact of its support for women's economic empowerment when crafting contracts—another welcome change from OPIC's statutes.

OPIC's investments were often criticized by developing country partners because they had to support U.S. sponsors. OPIC had a "U.S. involvement" requirement in the deals it signed, which amounted to "at least equivalent to 25 percent of the project company's equity," which could be met through "equity investment, long-term debt investment, other U.S. contracts (such as construction, operating, maintenance or service contracts, off-take purchase arrangements and franchises) or by any combination of these."²⁷ The DFC will ease this U.S. requirement to a preference, thereby allowing the DFC to better operate in areas where U.S. investors refuse to go.

Changes to the Management and Budget

To carry out its mandate, the DFC will be led by a board of directors and a management team consisting of the chief executive officer (CEO), a deputy chief executive officer, and three new positions: a chief risk officer (CRO), a chief development officer (CDO), and a dedicated inspector general (IG). The CRO will be responsible for identifying, assessing, monitoring, and managing risks to the DFC, including the diversification of its portfolio. By overseeing the DFC's full suite of projects, the CRO will be able to ensure project risks are not concentrated in any one region or development finance tool. The CDO is tasked with coordinating the DFC's collaboration with other U.S. development agencies such as USAID, the Department of State, and the MCC, among others (Box 3). The CDO will ensure the DFC leverages the expertise, research, and data of fellow development agencies to advise investment decisions and achieve the greatest development impact across its portfolio.

26. U.S. Congress, House, *Build Act of 2018*, H. R.302-1, 115th Cong., 2nd sess. https://www.opic.gov/sites/default/files/files/BILLS-115hr302_BUILDAct2018.pdf; Congressional Research Service, *BUILD Act: Frequently Asked Questions About the New U.S. International Development Finance Corporation* (Washington, D.C.: Congressional Research Service, 2019), <https://fas.org/sgp/crs/misc/R45461.pdf>.

27. "OPIC Facts Sheet: U.S. Connection Requirements for OPIC-Supported Projects," OPIC, February 2017, <https://www.opic.gov/sites/default/files/files/us-nexus-fact-sheet-2017.pdf>.

BOX 3: USAID-DFC COLLABORATION²⁸

A new report submitted to Congress lays out how the United States Development Finance Corporation (DFC) and the U.S. Agency for International Development (USAID) will work together in the future. These institutions are expected to draw from each other's tools, know-how, and staff members, enabling each agency to work more efficiently while ensuring proper—and thorough—monitoring of each other's work through a comprehensive training plan. Their activities should complement each other to maximize the quality of results (e.g., while the DFC develops investment deals, USAID will monitor and evaluate transactions).

- **Institutional linkages** between the DFC and USAID are expected to be implemented through structural improvements, with better coordination in policymaking and increased collaboration on development, foreign policy, and national security issues. The **chief development officer** will supervise and coordinate activities between the DFC and USAID (e.g., making sure they have access to the toolkits, they are prioritizing the right sectors, etc.). The DFC will coordinate meetings for a **Development Finance Coordination Group** (DFCG), which will be comprised of high-level representatives from not only the DFC and USAID, but also the Export-Import Bank (EXIM), Millennium Challenge Corporation (MCC), United States Trade and Development Agency (USTDA), the U.S. Trade Representative (USTR), and the Department of Labor. The DFCG will exist as a forum to share ideas and information on the DFC's priorities, transactions, and policies while U.S. embassies and consulates and USAID missions will oversee country-specific DFC coordination abroad. The DFC's **Office of Development Policy** (ODP) will also oversee individual transactions and ensure that they have the proper strategic and developmental impacts in addition to facilitating coordination between the DFC and various U.S. agencies. The ODP will do this through its key units: the **Development-Coordination Unit** (interfacing with USAID, State, and MCC by offering analytical, operational, and training support); the **Development-Assessment Unit** (expert evaluation of transactions and technical support); the **Policy-Assessment Unit** (analyzing and monitoring projects and ensuring compliance with DFC requirements); and the **Technical-Assistance and Feasibility-Studies Unit** (overseeing technical/program assistance). Cooperation between the DFC and USAID will also be implemented through the **Department of Development Credit**, which will have a combination of DFC and USAID staff to provide transactional support and monitoring over missions from both agencies and enhance service efficiency (including through the reduction of time-consuming internal processes). The **Office of**

28. USAID and OPIC, *Coordination Report* (Washington, DC: USAID and OPIC, 2019), https://www.opic.gov/sites/default/files/files/CoordinationReport_Shelby_7_31_19.pdf.

Strategic Initiatives will also strengthen linkages with other U.S. agencies by increasing the frequency of their interactions with one another and reinforcing foreign policy alignment.

- **Programmatic linkages** offer transactional support through interagency cooperation and the leveraging of capabilities across the U.S. government. This will include improving debt and equity transactions, building new partnerships, and providing project-specific technical assistance. Moreover, it will provide support for mentoring and evaluation of projects, as well as oversight in compliance within the agencies, and ensuring exchanges of staff when appropriate. In addition, DFC liaisons will be stationed at U.S. embassies and USAID missions worldwide. Liaisons may be foreign service officers or other professionals who will serve as the missions' primary operational and programmatic linkages back to the DFC and region-based DFC staff.
 - **Budget linkages** will also play an important role in monitoring transactions and facilitating budget transfers between the agencies. With the help of advisers and experts, interagency support will be given to support private sector engagement.
-

In contrast to OPIC's fifteen-member board of directors, the DFC will have a nine-member board similar to the MCC that includes the secretary of state (chairperson), the secretary of the treasury, the secretary of commerce, the administrator of USAID (vice chairperson), the CEO of the DFC, and four nongovernment members. These four nongovernment members must be appointed by the president and confirmed by the Senate to serve three-year terms, with the possibility of reappointment for one additional term. Unlike OPIC, which had specific representation requirements for small business, cooperatives, and labor interests, the DFC's board has no such stipulation. In addition, the board requires only five votes to form a quorum for the transaction of business, which may help streamline the DFC's dealmaking process.

Major reviews, investigations, and inspections of OPIC's operations and activities were conducted by the USAID inspector general (IG). The DFC will now have its own inspector general, who will be paired with an independent accountability mechanism. The IG and independent accountability mechanism will produce an annual report for Congress and the board that outlines how the DFC has met its environmental, social, labor, human rights, and transparency standards. The DFC will also receive the guidance of an independent development advisory council, composed of no more than nine board-appointed representatives from international development think tanks, NGOs, advocacy organizations, foundations, and other institutions. The council and newly formed risk committee and audit committee exist to offer suggestions for the DFC to better meet its development mandate and create a reasonable risk profile.

To carry out its mandate, Congress will appropriate a certain amount of money each year for the DFC's operating expenses. That money is offset by the fees and revenues the DFC

collects each year, making it a self-sustaining entity.²⁹ The DFC can also receive transfers from USAID and the State Department, for example, to allow USAID to fund DCA activities related to their projects.³⁰

Regarding administrative and program expenses, OPIC was appropriated \$79.2 million in fiscal year 2018.³¹ For FY 2020, the Trump administration requested a budget of \$98 million to be used for administrative costs (which includes \$10 million related to merging the DCA into the DFC) and \$2 million will go towards the establishment of the DFC's new Office of Inspector General. An additional \$200 million will be used for program funds: \$50 million goes towards credit subsidies, technical assistance, and special projects and programs, while the remaining \$150 million will be for equity investments. The DFC and State/USAID will also have a \$25 million "matching fund" to incentivize program and project coordination.³²

Current funding allocations may cause concerns regarding the DFC's staffing as critical components to the agency's success will be its ability to deploy new financing tools, measuring impact, and more local presence in partner countries.³³ Furthermore, there are worries about the president's budget request of \$150 million for equity investments because, for budgeting purposes, they are being scored (or treated) the same as grants (with a predetermined zero-dollar return on all equity investments), restricting the DFC's leveraging power. Ideally, the Senate Appropriations Committee will soon implement language to adjust the budget scoring rules for equity investments by utilizing a "net present value" approach which would more closely mimic the scoring of other DFIs and how banks adjust for risks.³⁴

Changes in Geographical Coverage

In making investments, the DFC will have to document that its interventions are additional (that is, they encourage private capital and do not compete with it), not distortive of markets (through government subsidies or crowding out private sector lending), and not displacing U.S. jobs.³⁵

For its geographical coverage, just like OPIC, the DFC is required to focus on low-income and lower-middle-income countries as defined by the World Bank. Nevertheless, OPIC has traditionally been able to support higher-income countries in projects that are "highly developmental, focus on underserved populations, or support U.S. small businesses."³⁶ While not dramatically different from OPIC, the DFC will have to focus on low- and lower-middle-income countries except in rare cases. This should reinforce its development

29. The DFC constitutes a Corporate Capital Account housed in the U.S. Treasury that generates income through fees, interest, returns on investments, and transfers of unexpended balances from predecessor agencies. A share of these funds will be used for the DFC's operating and program expenses, while the rest will go back to the Treasury, through an annual appropriations process.

30. Sec. 1434 of the BUILD Act. See: Congressional Research Service, *BUILD Act: Frequently Asked Questions*.

31. Congressional Research Service, *BUILD Act: Frequently Asked Questions*.

32. "Executive Budget Summary: Development Finance Corporation," OPIC, <https://www.opic.gov/sites/default/files/files/fy2020-executive-budget-summary.pdf>.

33. Todd Moss and Erin Collinson, "USDFC Monitor: Why Is the White House Scuttling its Biggest Development Win? Four Hidden Daggers Pointed at the Heart of the New USDFC," Center for Global Development, April 2, 2019, <https://www.cgdev.org/blog/why-white-house-scuttling-its-biggest-development-win-four-hidden-daggers-pointed-heart-new>.

34. Adva Saldinger, "2 months until launch, how is the new US DFI shaping up?," *Devex*, July 30, 2019, <https://www.devex.com/news/2-months-until-launch-how-is-the-new-us-dfi-shaping-up-95369>.

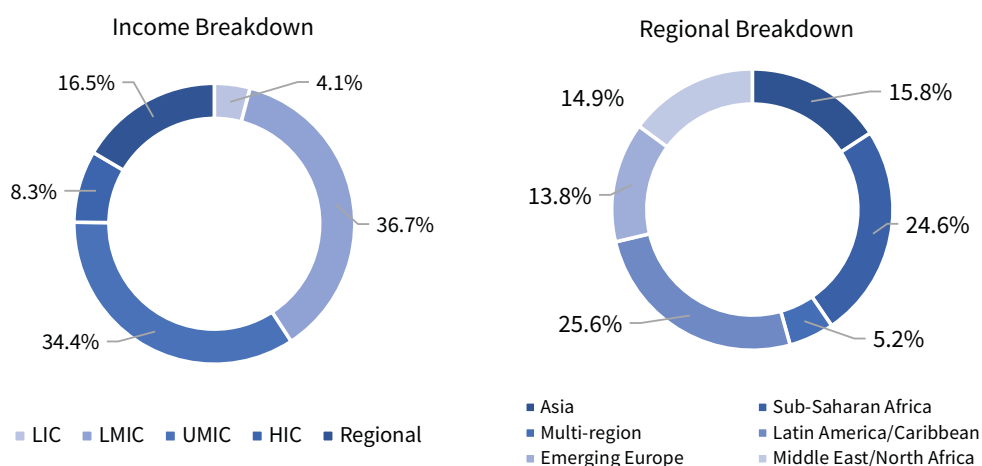
35. Sec. 1452 of BUILD Act.

36. Congressional Research Service, *BUILD Act: Frequently Asked Questions*.

mandate while helping ensure it operates most often where there are market failures instead of in competition with markets.

Over half of OPIC's \$22.8 billion portfolio is in sub-Saharan Africa, Latin America, and the Caribbean. Asia, emerging Europe, and the MENA regions each make up about 15 percent each, and multi-region deals comprise the remaining 5 percent of OPIC deals. An estimated 26 percent of OPIC's deals have been in states classified by the Organization for Economic Cooperation and Development (OECD) as fragile. In terms of income category, 45 percent of its portfolio is in low-income and lower-middle income countries, 38 percent in upper-middle and high-income states, while regional deals made up the final 17 percent (Figures 1 and 2).³⁷ In terms of sectoral support, investments were mainly geared towards power projects and the financial sector.

Figures 1 and 2: OPIC's Portfolio (2003-18)



Source: CSIS elaboration based on OPIC's database: <https://www.opic.gov/content/opic-data>.

Note: Income breakdown is based on the World Bank classification of countries.

<https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups>

LIC= Low Income Country (GNI per capita is less than \$1,025) LMIC= Lower-Middle Income Country (GNI per capita is between \$1,026 and \$3,995) UMIC= Upper-Middle Income Country (GNI per capita is between \$3,996 and \$12,375)

HIC= High Income Country (GNI per capita is greater than \$12,376)

Changes in the Development Finance Toolbox

In terms of development finance instruments, in the past, OPIC primarily provided direct loans (70 percent of its portfolio in 2018) followed by political risk insurance (17 percent) and supporting investment funds with debt (13 percent).³⁸ The BUILD Act provides the DFC a new toolkit, allowing it to utilize equity authority to fund projects, provide technical assistance and conduct feasibility studies, leverage the use of local currency loans and first- loss guarantees, and create new enterprise funds (Table 1).³⁹ In terms of support limits, no entity may receive more than an amount equal to 5 percent of the DFC's maximum contingent liability.

37. CSIS analysis based on "OPIC Portfolio": "OPIC Data," OPIC, <https://www.opic.gov/content/opic-data>.

38. Congressional Research Service, *BUILD Act: Frequently Asked Questions*.

39. Daniel Kliman, "To Compete with China, Get the New U.S. Development Finance Corporation Right," Center for a New American Security, February 6, 2019, <https://www.cnas.org/publications/commentary/to-compete-with-china-get-the-new-u-s-development-finance-corporation-right>.

Table 1: Development Finance Instruments: OPIC vs. DFC

Instrument	OPIC	DFC	What Changed? Why Does It Matter?
Equity Investments⁴⁰	No	Yes	<p>The DFC can now make equity investments as a minority investor in any entity or investment funds. Investments in equity are limited to i) 30 percent of the total project and ii) a total limit of 35 percent of the DFC's total investment exposure.⁴¹</p> <p>Many companies in the developing world are at the incubator stage. Such companies may want a “true partner” investor as their company grows; therefore, equity may be preferred over alternate forms of financing. Under OPIC, the United States was only able to participate in deals as a senior lender and thus paid first if the deal went south. This disincentivized other DFIs from doing deals with OPIC. Equity authority provides the DFC a better chance to partner in a deal with other DFIs on an equal footing.</p>
Political Risk Insurance⁴²	Yes	Yes	Issue insurance and reinsurance to the private sector and sovereign entities.
Loans and Guarantees⁴³	Yes	Yes	<p>The DFC will also make changes to risk-sharing loan guarantees on projects. Whereas OPIC needed other parties to bear at least 50 percent of the risk of loss on a project, the DFC will reduce this threshold to 20 percent, thereby greatly reducing another barrier to partnerships.</p> <p>Loans or guarantees from the DFC are on a senior basis (i.e., paid first) or pari passu (i.e., on an equal footing) with other senior debt.</p> <p>Unlike OPIC, the DFC can offer loans and guarantees in local currencies, which is important for SMEs, infrastructure, and service-related sectors. Local currency loans will be very useful to partner with local investors.</p>
Enterprise Funds⁴⁴	USAID	Yes	The DFC will be able to establish new enterprise funds (U.S. government funding to invest in private equity and credit in emerging markets). USAID remains in charge of all existing enterprise funds.
Technical Assistance and Feasibility Studies⁴⁵	Limited	Expanded	OPIC was able to provide technical assistance in special circumstances, but it was not a routine function of its country engagement. The DFC will have the ability to provide technical assistance and conduct feasibility studies as part of the offers it makes to country partners.
Special Projects and Programs (Grants)⁴⁶	No	Yes	The DFC has the authority to undertake “special projects and programs” to assist specific transactions. These special programs include financial and advisory support and technical, professional, and managerial skills training. Incentives, grants, and studies for women's economic empowerment, the energy sector, and microenterprise and small business activities can now be funded by the DFC. ⁴⁷
Blended Finance⁴⁸	Blended finance mainly under USAID (through DCA, PCM, INVEST, and the Global Development Lab)	Yes	<p>Blended finance has many definitions. It is a strategic approach for development institutions to mobilize private capital by combining concessional finance with other sources of finance (from DFIs or commercial investors) to help meet development goals.⁴⁹ Although the BUILD Act does not specifically refer to blended finance, the DFC can partner with other donors or philanthropic capital, pairing its financing in a complementary way to help support projects or by using its available grant funds, feasibility studies, or technical assistance capacities.</p> <p>The DFC will collaborate more closely with other U.S. agencies like USAID and MCC and thus can blend their funding sources with those of the DFC.</p>

40. U.S. Congress, House, *Build Act of 2018*, Title II, Sec.1421 (c), p.10.

41. “How the investment process works,” OPIC, <https://www.opic.gov/what-we-offer/investment-funds/how-investment-process-works>.

42. U.S. Congress, House, *Build Act of 2018*, Title II, Sec.1421 (c), p.10.

43. Ibid., Title II, Sec.1422 (b), p.14.

44. Ibid., Title II, Sec.1421 (g), p.11.

45. Ibid., Title IV, Sec. 1445 (c), p.24.

46. Ibid., Title II, Sec.1421 (f), p.11.

47. Congressional Research Service, *BUILD Act: Frequently Asked Questions*.

48. U.S. Congress, House, *Build Act of 2018*, Title IV, Sec. 1445 (b), p.23.

49. Conor M. Savoy and Aaron N. Milner, *Blended Finance and Aligning Private Investment with Global Development: Two Sides of the Same Coin* (Washington, DC: CSIS, 2018), https://csis-prod.s3.amazonaws.com/s3fs-public/event/180313_Savoy_BlendedFinance_Web.pdf.

Changes in Performance Measurement

The BUILD Act stipulates that the DFC develops a new performance management system to monitor its portfolio, and it will ensure project data and performance measures are publicly available online.

In consultation with dozens of development finance experts, the DFC is in the midst of developing a new performance measurement system for managing the organization and its portfolio as well as a new index for measuring development impact. This performance metric will be used to standardize the monitoring and evaluation of DFC projects and inform the DFC's leadership on adjustments to make on its investments going forward.⁵⁰

Greater Thrust to Collaborate with U.S. Allies

One of the DFC's primary thrusts is to coordinate with other DFIs in order to leverage resources so that there is greater development impact at the aggregate (Sec. 1411 [5]). With new instruments and more flexibility to work with a range of firms (rather than solely those that are U.S.-owned), the DFC will have more avenues to partner with U.S. allies on more complex, higher-risk projects. The DFC will be able to expand its impact by partnering with other DFIs by mobilizing resources from other investors through loan syndications, equity investments, and other mechanisms. This will provide an opportunity for the DFC to leverage its capital by bringing private investors into projects.

OPIC has recently been more engaged in signing MOUs and conducting joint projects (Box 4), indicating a shift towards a more collaborative approach.]

50. Congressional Research Service, *BUILD Act: Frequently Asked Questions*.

BOX 4: OPIC'S RECENT PARTNERSHIPS

- In 2018, OPIC signed its first trilateral agreement, the Trilateral Infrastructure Partnership, which united the United States with Japan's Bank for International Cooperation (JBIC) and Australia's Department of Foreign Affairs and Trade (DFAT) and Export Finance and Insurance Corporation (Efic). The partnership calls for the three nations to identify opportunities for joint infrastructure projects that will stoke economic growth, enhance digital connectivity, and meet shared development priorities in Indo-Pacific markets.⁵¹
 - In 2018, OPIC and the Inter-American Development Bank partnered to launch the first gender-focused fund for Latin American and Caribbean countries. The two agencies are partnering to invest in small- and medium-sized women-owned enterprises as part of OPIC's 2X initiative.
 - OPIC also signed an MOU with the International Finance Corporation (IFC) to further the 2X agenda. The importance of this relationship is not only to engage directly with the IFC, but also to build potential relationships with other signatory countries and provide the opportunity to establish global networks.⁵²
 - In 2019, OPIC developed an MOU with the European Development Finance Institution and FinDev Canada which established the DFI Alliance with the aim of increasing coordination in transactions, operations, and policy-related work.⁵³
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51. "OPIC Signs MOU Establishing DFI Alliance with Key Allies," OPIC, April 11, 2019, <https://www.opic.gov/press-releases/2019/opic-signs-mou-establishing-dfi-alliance-key-allies>.

52. "OPIC and IFC Sign Memorandum of Understanding to Promote Resource Efficiency in Building Projects in Emerging Markets," OPIC, August 31, 2018, <https://www.opic.gov/press-releases/2018/opic-and-ifc-sign-memorandum-understanding-promote-resource-efficiency-building-projects-emerging-markets>.

53. "OPIC Signs MOU Establishing DFI Alliance with Key Allies," OPIC.

3 | A Strategic Vision for the DFC

The launch of the DFC provides a renewed opportunity for the United States to further its private sector development efforts abroad and mobilize significant private investments through a development model that is based on market principles, transparent processes, and debt sustainability. The DFC will have to operate in spaces that have traditionally not been its predecessor's core business and thus will be pushed to cross boundaries. Yet, this also provides a chance for the DFC to innovate, take on more risk, and leverage the work that other U.S. agencies and development partners are carrying out to build robust private sectors abroad.

On the other hand, some of the expectations about what the DFC can do are unrealistic and need to be highlighted. It is important to recognize that the DFC has its limitations. This is just one agency in the development finance ecosystem and thus will not be able to solve all development challenges on its own.

DFC's Guiding Principles

As a new institution, there are certain principles that CSIS believes that the DFC needs to underscore and advertise as adding unique value going forward. These principles will help the institution cement its role as a trusted development partner, both for countries seeking investments and allies that want to work closely with U.S. institutions. We propose five guiding principles that the DFC should follow as it embarks on its new role:

VISIBILITY

There is a sense that the United States is losing ground in many regions of the world and lacks visibility vis-à-vis other development players. For certain regions, U.S. economic and development presence has dwindled, and Chinese presence has taken its place. In 2006, the United States was the principal trade partner for close to 130 nations. Just 10 years later, this number had dropped to 76 as China has risen to become the top trading partner for 124 countries.⁵⁴ In Africa, where a large share of the trade and investment opportunities lie, the United States has lost significant ground and is withdrawing from the region.⁵⁵ In 2016, U.S. exports to Africa hit a 10-year low, with sub-Saharan Africa now

54. United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2019: Special Economic Zones* (New York, NY: United Nations, 2019), https://unctad.org/en/PublicationsLibrary/wir2019_en.pdf.

55. Judd Devermont, *The World Is Coming to Sub-Saharan Africa. Where Is the United States?* (Washington, DC: CSIS, 2018), <https://www.csis.org/analysis/world-coming-sub-saharan-africa-where-united-states>.

accounting for only 0.9 percent of total U.S. exports.⁵⁶ Chinese trade, investments, and lending have been on the rise. Chinese lending to the continent increased tenfold from 2012 to 2017.⁵⁷ Moreover, China's FDI in Africa has steadily increased from \$1 billion per year in 2004 to over \$40 billion per year in 2016, mostly in the energy and infrastructure sectors.⁵⁸ The stock of China's FDI in Africa increased by more than 50 percent from 2013 to 2017, while the United Kingdom and the United States have seen their total FDI stocks in Africa dwindle during the same time period.⁵⁹

Visibility is not only valuable commercially but also offers diplomatic, military, and political benefits. Some of the United States' visibility issues can be attributed to the perception that China invests in large-scale infrastructure projects which allow local politicians to take credit and “cut the ribbon,” while the United States works in sectors that are less apparent to the public. The United States can increase its visibility by making investments in key sectors or regions that will have significant development impact for a country. One example is in the Mindanao region of the Philippines with its high youth unemployment and presence of radical groups. Another example is the development of secondary cities in Guatemala to foster better job opportunities and public services so that citizens have fewer incentives to emigrate.

STANDARDS, QUALITY, AND TRANSPARENCY

The DFC should always follow a high-quality approach in its practices. It cannot compromise on the high standards regarding economic, social, environmental, and governance in its investment process and procurement practices. It will have to be transparent about the reasons for selecting projects, explain why its interventions provided additional value (that is, it “crowded in” private capital), and illustrate the financial and development impacts of its investments. By developing a clear performance reporting system, the agency can disclose the data on projects in a more detailed and user-friendly way.

FLEXIBILITY

The BUILD Act grants the new institution a strong development toolbox with added financing instruments, including equity authority, technical assistance, and guarantees in local currency. This new and expanded toolkit provides the flexibility needed to make investment decisions. The DFC can use its development finance toolbox more strategically in order to both attract investments from abroad and spur the domestic capital base. The equity tool also provides added flexibility to support earlier stage businesses or businesses in sectors where debt does not make sense, to support opportunities that need technical assistance, and to collaborate with other DFIs—for example, by being able to co-invest *pari passu* (i.e., on an equal footing with others) in equity funds. Moreover, the relaxation of the U.S. sponsorship requirement allows greater flexibility for the agency to operate in geographies where U.S. firms are not present or unwilling to invest in.

56. The President's Advisory Council on Doing Business in Africa (PAC-DBIA), *Report on Top Issues U.S. Companies Face in Approaching, Competing, and Operating in African Markets* (Washington, DC: PAC-DBIA, 2017), <https://www.trade.gov/pac-dbia/docs/PAC-DBIA%20Issues%20Report%20-%20Nov%202017.pdf>.

57. Abdi Latif Dahir, “Chinese lending to African countries jumped tenfold in the last five years,” *Quartz Africa*, November 15, 2018, <https://qz.com/africa/1463948/chinese-lending-to-african-countries-jumped-tenfold-in-the-last-five-years/>.

58. Ibid.

59. UNCTAD, *World Investment Report 2019*.

COLLABORATION

The DFC needs to pursue a more coordinated approach with other U.S. agencies on the ground, including USAID, the State Department, MCC, and the United States Trade and Development Agency (USTDA), as it approaches economic development in a country. This collaborative approach should also guide the work of the DFC with the private sector and other DFIs by pursuing joint projects on the ground. This will be particularly important in more fragile contexts where the private sector is nascent and overlapping efforts would be wasteful. Competing for a handful of projects in these more difficult countries would be ineffective and would not serve the country's development needs.⁶⁰

IMPACT

Finally, the DFC's projects need to provide impact—that is, focused in sectors that will create lasting change to the country by promoting economic growth and jobs, driving innovation, or fostering greater social and economic inclusion. Project selection will be crucial. The DFC will need to rely on private sector growth diagnostics undertaken by MCC, for example, in order to ensure that its interventions are truly filling a necessary gap and not simply muscling out the private sector. OPIC has been financially sustainable, but that does not mean the DFC cannot sacrifice some returns for development impact.⁶¹ The DFC has space to be more flexible on certain financial terms—including rates, grace periods, and maturities—to support higher, more sustainable impact and crowd in the growing impact investor base.

Opportunities and Limitations for the DFC

OPPORTUNITIES

First, the DFC provides an opportunity for different U.S. agencies to coordinate the efforts they are undertaking in the economic growth and private sector development space. Through the DFC, the United States can support the work that agencies such as USAID, the Department of State, and the MCC undertake daily. The DFC will complement long-standing presidential initiatives such as Power Africa, Feed the Future, or more recent ones such as Prosper Africa and the Women's Global Development and Prosperity Initiative. USAID's progress on the enabling environment for private sector development by partnering with host country regulators, across an industry, through chambers of commerce, or with particular companies is a critical aspect of the DFC's success. USAID's relationships, expertise, and long-term engagement in a country make it uniquely positioned to create the investment environment needed for finance to work in. For example, the significant DFI investments made in the telecoms sector across Africa and Afghanistan required regulatory reforms, which agencies such as USAID or the World Bank Group carried out. USAID will need to continue to work in a wide number of private sector development issues to enable future DFC investments.⁶² The USAID-DFC

60. Paul Collier, Neil Gregory, and Alexandros Ragoussis, *Pioneering Firms in Fragile and Conflict-Affected States Why and How Development Finance Institutions Should Support Them* (Washington, DC: The World Bank, 2019), <http://documents.worldbank.org/curated/en/602071552331498209/pdf/WPS8774.pdf>.

61. Title III, Sec. 1434 and Title I, Sec. 1412 article b): "In carrying out its purpose, the Corporation, utilizing broad criteria, shall take into account in its financing operations the economic and financial soundness and development objectives of projects for which it provides support under title II."

62. Daniel F. Runde, "Modernizing Development Finance" (statement before the Senate Committee on Foreign Relations, Washington, DC, May 10, 2018), https://csis-prod.s3.amazonaws.com/s3fs-public/congressional_testimony/ts180510_dan_runde_testimony_sfrc.pdf.

coordination report, submitted to Congress in August 2019, outlines the establishment of an interagency Development Finance Coordination Group, which will identify the specific ways U.S. foreign policy and development forums can support the DFC in its goals.⁶³

Second, the DFC provides an opportunity for the United States to work together with U.S. allies and likeminded DFIs via specific projects, processes, and/or technical assistance. For example, on April 11, 2019, OPIC signed a memorandum of understanding (MOU) with FinDev Canada and European Development Finance Institutions (EDFI) to establish a "DFI Alliance" (Box 5).⁶⁴ The goal of this alliance is to improve cooperation among these institutions on transactions, operations, and policy-related work. Another joint announcement is the G7's 2X Challenge—a new commitment to mobilize \$3 billion by 2020 for women's economic empowerment (June 2018).⁶⁵ These high-level announcements must be matched with concrete actions and projects in countries; otherwise, they risk simply being a statement of good intentions. The DFC has a chance to devise innovative approaches so that DFIs investments can be combined into a force multiplier. The DFC can use its new authorities to help mobilize multiples of private capital—especially if done in tandem with other DFIs.

Third, the creation of the DFC also provides an opportunity for the United States to rethink—and perhaps rebalance—its geographical reach into countries and regions that are of geostrategic importance in terms of countering China, addressing migration, and the youth bulge. Part of DFC's mandate is to provide development impact and crowd in private capital sector in more challenging geographies, such as low-income countries and lower-middle-income-countries.⁶⁶ Some of these countries are fragile and conflict-affected areas facing a whole set of development challenges, including political instability, rising poverty and inequality, macroeconomic uncertainty, anemic private sector growth, and significant environmental threats. According to a report by James Michel, the correlation between state fragility, violence, and poverty is non-negligible.⁶⁷ Of the 58 states classified by the OECD as fragile in 2018, 80 percent are low income or lower-middle income with poverty becoming increasingly concentrated in fragile and conflict-affected states (FCS). By 2035, the OECD predicts that 80 percent of the world's extremely poor will be in their listed fragile states.

OPIC currently invests 26 percent of its portfolio in countries classified as fragile by the OECD. The confluence of changing demographics, violence, and lack of private capital in specific regions will require the DFC to refocus its investments in key geostrategic regions (e.g., the Indo-Pacific) and fragile contexts. This will likely include the Sahel in North Africa (Burkina Faso, Chad, Mali, Mauritania, and Niger), the Northern Triangle of Central America (El Salvador, Honduras, and Guatemala), and Haiti, although it will be difficult for the DFC to generate deal flow in some of these countries. This remapping of the U.S. geographical

63. USAID and OPIC, *Coordination Report*.

64. "OPIC Signs MOU Establishing DFI Alliance with Key Allies," OPIC.

65. "G7 DFIs Announce '2X Challenge' to Mobilize \$3 billion to Invest in the World's Women," OPIC, June 9, 2018, <https://www.opic.gov/press-releases/2018/g7-dfis-announce-2x-challenge-mobilize-3-billion-invest-worlds-women>.

66. According to World Bank classification, there are currently 31 low-income countries, 47 lower-middle income countries, and 61 upper-middle income countries.

67. James Michel, *Managing Fragility and Promoting Resilience to Advance Peace, Security, and Sustainable Development* (Washington, DC: CSIS, 2018), <https://www.csis.org/analysis/managing-fragility-and-promoting-resilience-advance-peace-security-and-sustainable>.

footprint must be carried out in conjunction with the USTR (to ensure countries comply with their trade obligations), the U.S. Department of State, USAID, and MCC.⁶⁸

By working in more challenging environments, the DFC will be making riskier investments. Some projects will fail, but that should be expected—and some national security experts say encouraged—when working in more difficult contexts or investing in riskier projects. The DFC will have to weigh two competing mandates: taking on more risk to achieve development impact and ensuring the financial soundness of its investments. Thus, the DFC portfolio will need to be diversified enough so as not to compromise its development and financial objectives. The functions and interaction between the two new management positions—the CRO and the CDO—need to be decisive to create such a balance. The DFC’s newly developed performance measurement system, which will evaluate the performance of all the projects, will provide a strong complement to these roles.

Finally, the DFC has more options and flexibility when working with private sector partners because the BUILD Act has relaxed the requirement that mandated U.S. business, NGOs, or individuals to sponsor the projects. The DFC will now give preferential treatment (and not a requirement) to those projects that are supported by U.S. citizens or U.S. corporations. This allows the agency to work with a diverse set of partners in places where U.S. entities might not be present and enhance U.S. visibility overall. This change is important in contexts such as Afghanistan and Africa, where U.S. soft power is needed but is almost impossible to convince credible U.S. investors to go due to security concerns or the absence of legal and regulatory frameworks.⁶⁹ In practical terms, there can be a broad interpretation of the “U.S. preference” clause.

LIMITATIONS

The launch of the DFC comes with high expectations. Yet it is important to highlight what the agency was not intended to achieve and will not be able to achieve going forward. No agency, no matter how large it is in terms of financial resources or staffing, will be able to confront the most pressing development problems on their own. The challenges of migration, violent extremism, and countering China are issues that need a joint response from developing countries and development agencies alike.

First, the DFC is not the equivalent to China’s BRI. What China has to offer is a very distinct financing model—often export-based and politically-driven—compared to the Western approach. China currently offers big pots of money (sponsored by the Chinese state) for infrastructure without focusing on development impact, capacity building for the country, or debt sustainability considerations. But this could change if the United States works with like-minded partners to sway China to adopt Western standards and approaches and/or builds the capacity of recipient nations to negotiate better deals with the Chinese. The DFC could use its projects to show countries that quality and environmental and financial sustainability prevail over cheap and quick investments. The DFC could urge countries to demand those attributes from Chinese investments and use its technical assistance ability to train them in that process. However, the United States also needs to recognize where to draw the line with China and where

68. Congressional Research Service, *BUILD Act: Frequently Asked Questions*.

69. Runde, “Modernizing Development Finance.”

cooperation will not work. For example, the United States will not compromise on its standards and transparency.

Second, the DFC will not be able to double its commitments in the first years. The agency will need some time to get comfortable with its added functions. The timing of riskier investments must be done gradually. There are high expectations that the DFC will begin to structure deals in more challenging countries and take on more risk. But taking on more risk will mean that some of the projects might fail. Given that there are a few DFC skeptics and opponents of development finance, it will be more prudent, at least in the first two years, for the DFC to plan investments carefully to strike the right balance between risk and returns of its interventions and to clearly communicate and manage expectations that the DFC *deliberately* expects a higher failure rate and why. This recommendation should be especially heeded when first mobilizing the DFC's new equity authority. The DFC will have to use this tool gradually and strategically to produce big wins.

Third, similar to OPIC, there are certain sectors or locations that the DFC will have limitations and should not invest in because of their environmental and social impacts and/or disrespecting workers' rights and human rights.⁷⁰ Prohibitive categories include deals that have large negative environmental impacts and high human displacement, such as projects that emit large amounts of toxic materials (asbestos, radioactive materials, etc.); the construction of large dams that significantly disrupt ecosystems; programs related to tobacco, gambling, or illegal products; or activities that have used forced and child labor. Moreover, the DFC should not structure deals in sectors or regions where private financing is accessible. That is, it must prove that its investments are additional and not competing with the private sector. In that regard, the DFC's role should be limited and time bound: once private financing is accessible, the DFC presence is no longer needed in that country.

Finally, the DFC should not be thought of as a substitute for traditional U.S. foreign aid but rather complement foreign assistance efforts. As countries move up in the development ladder, they will need less foreign aid and will be able to rely more on their own domestic resources (such as taxes and savings) and private investments to finance their development challenges. However, grants will still be needed in countries with inadequate government capacity and weak economic fundamentals to tackle humanitarian, environmental, and health emergencies. Foreign aid will also fund initiatives that bolster international standards (such as human and labor rights) that are important in promoting democracy and good governance but are hard to quantify through a specific development outcome.

USAID's new development framework, the Journey to Self-Reliance, fully recognizes this and aims to help countries develop to a point where they no longer need foreign assistance.⁷¹ USAID will help countries graduate from foreign assistance in three ways. First, USAID will help countries improve their ability to raise public revenues and develop domestic capital markets to finance their own economic and social development. Secondly, USAID will help mobilize private capital and bring technical expertise from

70. United States Government Accountability Office (GAO), *Overseas Private Investment Corporation: Additional Actions Could Improve Monitoring Processes* (Washington, DC: GAO, 2015).

71. "The Journey to Self-Reliance," USAID, <https://www.usaid.gov/selfreliance>.

the private sector to support development programs. Thirdly, USAID will work with governments to enact reforms and strengthen their capacity to graduate from foreign aid. The DFC complements USAID's efforts in making countries self-reliant by helping them develop their private sectors. By making investments in sectors or countries that would otherwise be unable to attract private capital, the DFC can help fill private sector gaps arising from market failures.⁷²

72. Daniel F. Runde and Romina Bandura, "The BUILD Act Has Passed: What's Next?" CSIS, October 12, 2018, <https://www.csis.org/analysis/build-act-has-passed-whats-next>.

4 | Recommendations

With the new DFC coming on board, the United States has an opportunity to deploy its development agencies more effectively and bring a more coordinated approach to fostering the private sector in developing countries. The United States should reinforce its competitive advantages through the DFC by enhancing its presence abroad, investing in key strategic sectors, collaborating with other U.S. development agencies and allies, and using development finance tools more creatively.

The United States offers intangible qualities which need to be better communicated and marketed. Transparency in procurement processes, free-market economic principles, technology and knowledge transfers, increased environmental safeguards, debt sustainability assessments, quality infrastructure standards, and a willingness to invest in SMEs are some of the distinct advantages of the U.S. development finance approach. U.S. companies competing for contracts might have higher costs in the short term, but through lower lifecycle costs and the benefits of U.S. technical training, it becomes clear the United States is the better partner in the long term.

These are unique features that the DFC needs to highlight. Making this strong case is critical for the DFC and other U.S. agencies and allies to start winning more deals. The following section provides medium-term recommendations for the DFC as it begins its operations and starts making strategic investments in developing countries.

Manage Expectations and Set a Medium-Term Goal

First and foremost, the DFC will need to manage expectations. The DFC has largely been advertised to Congress and the American people as a silver bullet response to China's BRI. However, much of that work should fall to a reformed EXIM, even after the first two to three years of a transitional DFC. The DFC must be upfront that the first two years will be a transition period, and it will probably ramp up investments in year three using its full toolbox—especially in the more difficult geographical contexts. The board may want to consider cross-subsidizing projects in low-income/fragile contexts with safer investments in countries that have relatively strong existing private capital activity in its first two to three years. The DFC can begin to realistically pursue targets (such as \$8 billion per year in new commitments) at the five- to six-year mark after the DFC has more firmly settled on the appropriate levels of risk and reward for projects.

As the DFC starts operations, the new board and management must think about the kind of footprint the agency will have going forward. It is important for the success of the DFC to set a medium-term goal on what the agency wants to accomplish 10 years from now. Although the agency is authorized for seven years, the DFC board and management should be more ambitious and ask themselves, “What do we want to become 10 to 15 years from now?” Setting a numerical goal in terms of levels of commitment and development impact can drive the agency to become more focused. These numerical goals can consist of outcome goals (for example, “support 1 million jobs in the most fragile states” or “help create three new product markets and provide access to finance to 1,000 SMEs in low-income countries by 2030”) that will be accompanied by output goals (for example, it can set a target such as “reach \$10 billion in new commitments per year by 2030, with 60 percent of the portfolio in the world’s poorest countries [LICs and LMICs]” or “mobilize three times the amount of private capital through DFC investments”).

In pursuing this medium-term goal, the DFC will need to ramp up its work in more challenging countries—that is, the poorest and most fragile states. This will come with risk, and stakeholders will have to be more tolerant of failure. There is a myriad of unmet needs in many places, and the agency will be tempted to target a wide variety of countries and sectors. CSIS believes that the DFC should not overextend itself by targeting many countries and sectors. Particularly for fragile contexts, it should take a more focused approach by selecting a few countries and targeting specific sectors that could be transformational for the country. This will help build a critical mass of knowledge that will yield better development results: it will contribute to the understanding of what is and is not successful in more challenging contexts.

Finally, as the DFC reaches its seventh year in 2026, it will have showcased some of its positive impacts and share some of the lessons it has learned. At this point, Congress should consider reauthorizing the institution for another 10 years. Many bilateral DFIs around the world were set up permanently, and they do not require reauthorizations. The DFC may have to settle for another seven-year reauthorization, but with enhanced stability from Congress, the DFC can better cement its work and provide greater opportunities for development impact to materialize in more difficult contexts. In year seven, Congress should also consider indexing the DFC’s credit exposure of \$60 billion to account for inflation and ensure that it remains competitive with other modern DFIs.

Adopt a “Team America” Approach: Strategic and Coordinated

The United States is often perceived to “do development” in a piecemeal approach with various agencies supporting different needs with sparse coordination. The launch of the new DFC is a chance for U.S. development agencies to follow a more coordinated and holistic approach to private sector development abroad. The DFC has an opportunity to lead better interagency coordination by adopting a “Team America” approach in-country that brings together the expertise of different agencies. This commitment must come from the top of the agencies, with a clear message from Washington headquarters and the U.S. ambassador reaching staff of each agency working in-country. A system of rotational staff secondments among agencies could also be devised to create a greater understanding of what each agency does and increase collaboration efforts.

This interagency engagement can be modeled after the MCC, which enjoys high-level buy-in from its board agencies, or the Power Africa initiative, which seeks to bring the private sector and U.S. agencies together to address the constraints to project development and investment in sub-Saharan Africa's energy sector. Power Africa uses a transaction-centered approach whereby interagency transaction teams leverage U.S. financing tools, and a team of technical advisers helps governments implement those projects.⁷³ The DFC leadership must push itself out of its own silo which is naturally (and justifiably) wary that interagency coordination equates to interference.

For each country that the DFC decides to invest in, it should coordinate with other U.S. development agencies to prevent conflicts in their country approaches. The DFC needs to identify key strategic areas of impact in each country and focus on two to three key investments where the agency can make a difference. These areas of engagement might be smaller in size or riskier and will require the DFC to be pushed out of its comfort zone, trading financial returns for higher development impact.

Given that both MCC and OPIC have a demand-driven model—albeit with different demand signals—and an emphasis on infrastructure, the synergies between the two should be self-evident but have never been realized. Now that the DFC and MCC's boards nearly mirror each other and the MCC will have an observer seat on the DFC, the MCC should extend the same courtesy to the DFC and open their board process to the new agency.

The recently released USAID-DFC coordination report offers many answers to the above concerns, especially with regards to interagency collaboration plans, feasibility studies, oversight, accountability, monitoring and evaluation, technical assistance, and relationship management. However, one of the report's suggestions is to have DFC liaisons stationed at U.S. embassies and USAID missions to coordinate DFC engagement and serve as operational and programmatic linkages to the DFC.⁷⁴ Though it appears like an excellent form of collaboration on the surface because USAID and embassy staff are highly qualified and capable, these individuals do not have the expertise necessary to fully convey the capabilities of the DFC. In other words, these liaisons are not bankers or financiers; they do not possess development finance expertise.

Create Greater Awareness of the DFC and U.S. Development Finance Tools

Currently, there is confusion or a lack of knowledge in many countries on the kinds of U.S. development finance tools that already exist to support their endeavors. There is greater awareness of the role of USAID because that agency has significant presence on the ground. Part of the challenge for the new DFC is that it is only a Washington-based agency. This lack of in-country physical presence makes it difficult for people to understand what the institution has to offer and for the DFC to unpack what countries' stakeholders and development needs are.

73. "How We Work | Power Africa," USAID, <https://www.usaid.gov/powerafrica/howwework>.

74. USAID and OPIC, *Coordination Report*.

Moving forward, the DFC should attempt to more clearly outline and advertise the development finance instruments it has to offer, given that its new mandate has significantly expanded the toolkit it can use to include equity investments, first loss guarantees, and local currency financing.

This lack of understanding of the roles and development finance instruments of U.S. agencies is also apparent among the staff of U.S. development agencies. Many U.S. government officials do not understand the role of DFIs in general and what the DFC can do. The DFC is meant to collaborate with other U.S. agencies, but it can only do so if it communicates what its capabilities and intentions are. Without a coordinated understanding of the DFC's role in a broader foreign policy toolkit, U.S. development efforts will be distributed inefficiently, and the value-add of the U.S. brand will be diminished. To address this, it is critical that DFC officials in Washington create a communication strategy explaining the function and potential of the DFC both to the foreign policy community and other U.S. agencies. A system of staff secondments between the Department of State, USAID, MCC, and the DFC would also contribute to a better understanding of U.S. development finance tools and foreign policy goals and could increase interagency collaboration. More targeted training for the U.S. Foreign Service and USAID staff could also be strong complements to the DFC's communication strategy.

Staff the Agency Appropriately

As the DFC starts building up its portfolio, it will be important that Congress appropriate the necessary budgetary resources and staff so that it can carry out its enhanced mandate. OPIC's current budget stands at \$79 million to cover administrative expenses, with an additional \$26 million it receives from fees and services which are utilized to cover project costs.⁷⁵ For FY 2019 and FY 2020, the Trump administration has requested a budget of \$94 million and \$98 million, respectively, with no significant headcount increases. This includes \$10 million in expenses for transferring USAID's DCA office to the new DFC.⁷⁶ According to some estimates, this budget request actually represents a shortfall of \$21 million for FY 2019 and \$23 million for FY 2020.⁷⁷ This shortfall could curtail the DFC's ability to execute its operations in several areas including monitoring and evaluation, performance management, risk management, and others.

The BUILD Act mandates that the agency develop a new performance measurement system that will evaluate the development and financial impact of its investments and assess additionality. Projects will have to be evaluated ex-post the intervention. The DFC has convened a super committee of experts to help guide the agency as it develops its performance measurement system. In order to implement this new system, the DFC will require additional staff. This increased need for staff also translates to the new grant components and equity authority, which will require hiring a set of new investment officers or significant resources for retraining existing staff.

The DFC must also recognize the value of having representatives on the ground in geostrategic regions. Companies and institutions consider face-to-face interactions to

75. Moss and Collinson, "USDFC Monitor: Why Is the White House Scuttling its Biggest Development Win?"

76. "Executive Budget Summary: Development Finance Corporation," OPIC.

77. Moss and Collinson, "USDFC Monitor: Why Is the White House Scuttling its Biggest Development Win?"

be valuable and necessary for business dealings. To win deals, relationships are critical, and relationships built over the phone or during a few business trips per year cannot be cultivated to the same degree as regular, face-to-face interactions. The DFC should aim to have more local presence on the ground, but it does not need to create unnecessary bureaucracy such as setting up a local office in each country where it operates. To give an example, the International Finance Corporation (IFC) in 2012 had a staff of close to 4,000 people managing a portfolio of \$45.8 billion—that is, the IFC had 17 times more staff than OPIC yet managed a portfolio that was only three times as large.⁷⁸

The DFC could have more local presence using different approaches. It could adopt a regional approach by placing DFC staff in a key U.S. embassy covering a region. An in-country staff for the DFC enables greater synergy with other U.S. agencies and allies, forges stronger relationships with local political and business leaders, and increases the overall likelihood of winning and managing a deal. Another approach would be for the DFC to have local partners that help the agency source deals. These partners are companies that have been vetted by the U.S. government a priori and would help source deals and respond to business opportunities in a speedier manner. A third approach is to enter into explicit agreements or partnerships with other DFIs that are present on the ground to pursue deals together and join financing consortiums.

Strategically Collaborate with Allied DFIs

Taking a positive first step toward implementing concrete projects and initiatives, OPIC has recently signed an MOU with ally DFIs FinDev Canada and 15 member parties from EDFI to create the “DFI Alliance.”⁷⁹ There is a significant gap between intentions and concrete action in donor coordination of country activities. There is a need to leverage development financial instruments and implement specific initiatives that would help move the private sector development agenda forward. Through the work of the DFC, the United States has an opportunity to push for more tangible areas of collaboration among U.S. allies. This collaboration could take on a country-by-country approach or a sectors approach. Collaboration also means avoiding duplication. DFIs are sometimes chasing after the same few deals which leads them to undercut each other. Providing conflicting advice to countries where recommendations end up being at cross purposes is also ineffective and wasteful.

78. GAO, *Overseas Private Investment Corporation: Additional Actions Could Improve Monitoring Processes*.

79. “Memorandum of Understanding on Cooperation,” OPIC, April 11, 2019, https://www.opic.gov/sites/default/files/files/MOU_OPIC_FinDev_EDFI_11Apr2019_1.pdf.

BOX 5: THE DFI ALLIANCE - OPIC, FINDEV CANADA, AND EDFI⁸⁰

Cooperation among the development finance institutions (DFIs) will focus largely on four areas:

- Transactional Support: maximizing efficiency through support of transactions, risk-sharing, and diverse approaches to financing and co-financing.
 - Operational Support: support in data sharing, symmetry of information, and assistance in policy and other secretarial support.
 - Policy Process Support: joint coordination and participation in activities, development of appropriate platforms, reports, and monitoring.
 - Public Face Support: exploration of joint initiatives in launch and delivery of projects and increasing efforts to private sectors mobilization.
-

Some examples of areas where donors could undertake joint work to reinforce each other's resources and technical expertise also include:

- Financing
 - Setting up joint project preparation facilities
 - Co-financing (syndication) or co-guaranteeing projects (such as supporting specialized guarantee providers such as monolines in developing countries or using guarantees to back securitizations) to mobilize more private capital⁸¹
 - Investing in equity funds
- Technical Assistance
 - Delivering joint training in project preparation and procurement processes to government employees of developing countries
 - Assisting developing country government agencies in putting together a pipeline of bankable projects
- Processes
 - Conducting joint due diligence on projects
 - Applying same project selection process and documentation
 - Applying same environmental, social, and governance standards in projects
 - Adopting the standards of the Osaka G20 principles on quality infrastructure to attract similar DFIs, nations, and private investors who are willing to share risk on sustainable, quality development projects and build a coalition against China's investment standards
- Development Impact
 - Harmonizing definitions and indicators on "development impact"
 - Applying same impact measurement tools (project evaluations)

80. Ibid.

81. Forthcoming CSIS report on innovations in guarantees for development.

Use the New Development Finance Toolbox Strategically

COUNTRIES WITH MORE DEVELOPED PRIVATE SECTORS AND FINANCIAL INSTRUMENTS

In some countries, access to finance is not a major impediment for established firms. The banking sector might be liquid but only lends to large formal firms or to the government.⁸² Yet other sectors remain unserved. For example, smallholder farmers, women-owned businesses, and SMEs cannot access financing or can only do so at unreasonable rates. Banks also shy away from long-term riskier endeavors such as infrastructure development. Oftentimes, these countries have underdeveloped capital markets that prevent channeling savings to fund longer-term investments.⁸³

This set of countries needs more sophisticated development finance products and approaches such as expanding the use of loan portfolio guarantees for underserved sectors, helping create local capital markets to untap domestic savings, using grants to fund project preparation facilities, or making equity investments for startup and innovative firms that have the potential to make significant development impacts.

These are areas where the DFC working with other USG agencies can have significant impact:

- **Using Technical Assistance to Untap Local Savings and Create Robust Capital Markets:** The DFC could work with USAID's Office of Private Capital and Microenterprise (PCM) and other U.S. government agencies to help countries develop their capital markets.⁸⁴ Local capital markets offer a range of benefits to borrowers and investors alike, including better risk-sharing and allocating capital more efficiently. Local bond markets can be a source of long-term financing and can improve access to local currency financing to help manage exchange rate risk. Capital markets take a long time to develop and do so in stages: money markets and government bond markets are easier to set up than local bond markets, especially corporate bonds.⁸⁵ The DFC could also bring the technical assistance work of the U.S. Department of the Treasury's Government Debt Issuance and Management Program to help countries develop a bond market.⁸⁶ This U.S. Treasury team has worked with the governments of many developing countries to assist them in creating regulatory frameworks and markets for local currency government securities.
- **Scaling Up the Use of DCA Guarantees for Underserved Sectors:** The DCA, which will transfer its operations to the new DFC, provides loan portfolio guarantees to established banks and financial institutions to generate additional lending in underserved developing markets that have liquidity issues. These are partial

82. Paul L. Freedman and Reid W. Click, "Banks That Don't Lend? Unlocking Credit to Spur Growth in Developing Countries," *Development Policy Review* 24, no. 3 (May 2006), <https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1467-7679.2006.00325.x>.

83. Katsiaryna Sviryzdenka, *Introducing a New Broad-based Index of Financial Development* (Washington, DC: IMF, 2016), <https://www.imf.org/external/pubs/ft/wp/2016/wp1605.pdf>.

84. "Office of Private Capital and Microenterprise," USAID, <https://www.usaid.gov/pcm>.

85. Luc Laeven, *The Development of Local Capital Markets: Rationale and Challenges* (Washington, DC: IMF, 2014), <https://www.imf.org/external/pubs/ft/wp/2014/wp14234.pdf>; Cem Karacadag, V. Sundarajan, and Jennifer Elliott, *Managing Risks in Financial Market Development: The Role of Sequencing* (Washington, DC: IMF, 2003), <https://www.imf.org/en/Publications/WP/Issues/2016/12/30/Managing-Risks-in-Financial-Market-Development-The-Role-of-Sequencing-16548>.

86. "Office of Technical Assistance - Government Debt Issuance and Management Program," U.S. Department of the Treasury, <https://www.treasury.gov/about/organizational-structure/offices/Pages/OTA-government-debt.aspx>.

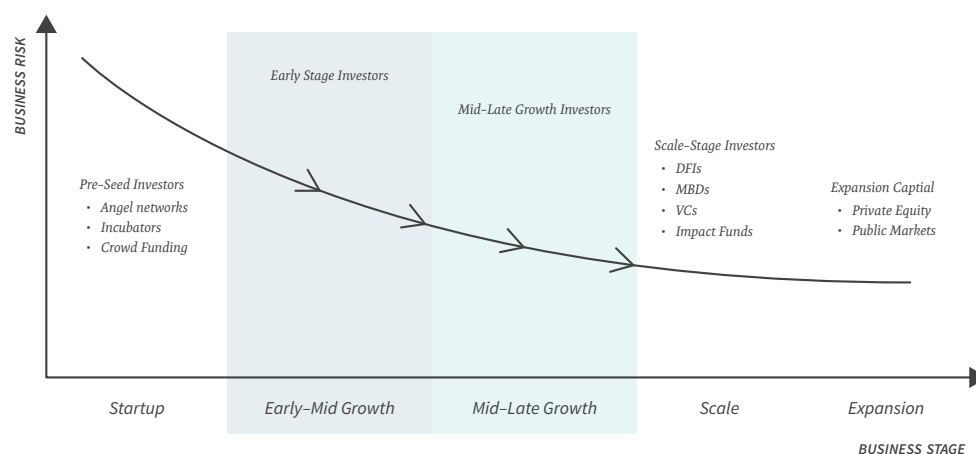
guarantees that the DCA provides to commercially viable banking institutions to incentivize them to expand their lending operations to sectors that have development impact such as agriculture, SMEs, and affordable housing. The guarantees cover no more than 50 percent of the loan amount and are offered in both as a foreign currency and local currency (although, in the latter, DCA commits to a \$ denominated exposure cap).⁸⁷ The DCA could work with local banks to provide guarantees for underserved sectors linked to global value chains such as agro-processing. Usually, local cooperatives or banks lend to established agricultural firms but do not reach small farmers that need longer-term financing to purchase equipment or access to a better variety of seeds in order to increase productivity.

- **Cultivating SMEs and Entrepreneurship through Anchor Investments and First Loss Guarantees:** Many sectors currently lack the financial, technological, and entrepreneurial capacities needed to scale up. For innovative ideas to become commercially successful, they need to go through five stages of growth: 1) startup, 2) early-mid growth, 3) mid-late growth, 4) scale, and 5) expansion (Figure 3).⁸⁸ Appropriate financing and support are needed at each stage. The level of risk associated with innovation decreases as the business moves up in stages. It is easier for these innovative firms to receive funding from more traditional financial institutions (MDBs, DFIs, impact funds, and venture capitalists) in the later stages as they scale and expand. As a result, the financing gap exists during the early-to-middle stages of growth where it is riskier to invest. U.S. investors have comparative advantages in structuring investments to enable this progression and business growth and are skilled at financing innovation and early risks. This is a chance for the DFC and other DFIs to invest in innovation. DFIs need to rethink their approach to investments and create new partnerships which will be willing to take on riskier and younger innovative ideas by providing equity. By working with U.S. investors, the DFC might help bring the financing to support innovation via SMEs in developing countries.

87. “Development Credit Authority: Putting Local Wealth to Work,” USAID.

88. Daniel F. Runde, Romina Bandura, and Sundar R. Ramanujam, *The Role of Development Finance Institutions in Enabling the Technology Revolution* (Washington, D.C.: CSIS, 2019), 8-9, <https://www.csis.org/analysis/role-development-finance-institutions-enabling-technology-revolution>.

Figure 3: The Five Stages of Innovation



Source: CSIS elaboration based on Neil E. Churchill and Virginia L. Lewis, “The Five Stages of Small Business Growth,” *Harvard Business Review* (May 1983), <https://hbr.org/1983/05/the-five-stages-of-small-business-growth>.

The DFC could back trusted and experienced private equity fund managers in-country and play a catalytic role in the formation of funds along certain key themes like innovation, agribusiness, SME growth, and infrastructure. The DFC could act as anchor investor in each fund and provide first-loss insurance for local private investors to untap the domestic capital held on the sidelines. The funds would also act as originators of debt financing opportunities for their portfolio companies, either through a separate debt facility funded by DFC or through a fast-track credit underwriting process. Through close interagency cooperation, the DFC could also assist the fund managers in securing technical assistance grants to create business accelerators that help emerging local companies become investable, scalable companies.

▪ **Using Its Equity Authority—Invest in Equity Funds and Set Up New Enterprise Funds:**

The DFC will have the ability to make equity investments and set up new enterprise funds. The BUILD Act allows the DFC to take equity positions as a minority investor in an entity or in investment funds, which could be used to partner in DFIs’ funds. To complement its equity investments, the DFC can launch a series of enterprise funds in key geostrategic countries or regions. The most DFC could have in outstanding equity investments is \$21 billion and enterprise funds would also be included under this cap. Enterprise funds function like private equity funds but use U.S. government funding to stimulate economic development by investing in the private sectors of developing countries. In a 2018 report, CSIS recommended that an enterprise fund for the Northern Triangle (El Salvador, Honduras, and Guatemala) would help provide more stability and economic opportunity to the region which needs stronger local markets, policy reforms, and more job opportunities domestically. A regional fund would achieve economies of scale and attract large-scale investments. The fund could help galvanize its three neighbors in strategic areas such as regional infrastructure and agro-processing and can achieve a positive demonstration effect for further investments into these three countries.⁸⁹

89. Daniel F. Runde and Romina Bandura, *Time for a Third Wave of Enterprise Funds* (Washington, DC: CSIS, 2018), <https://www.csis.org/analysis/time-third-wave-enterprise-funds>.

- **Using Its Grant Capacity to Increase the Developmental Impact or Improve the Commercial Sustainability of a Pipeline of Bankable Projects:** Investors often point to the lack of bankable and commercially viable projects as a major challenge in investing in developing countries. This is the case of infrastructure, where there is an annual investment gap of U.S. \$3.7 trillion.⁹⁰ Meeting this gap requires a more concerted effort in preparing a sound pipeline of bankable projects.^{91,92} Developing infrastructure projects consists of three phases: the preparation stage, construction stage, and the operation stage. The project preparation stage encompasses activities such as conducting feasibility studies, environmental impact assessments, and life-cycle cost analysis.⁹³ It is often the preparation stage that becomes a stumbling block for projects vying for private investments.⁹⁴ A 2019 Global Infrastructure Outlook report estimates that the cost of preparing and packaging projects can range between 5 to 10 percent of project value, with developing countries seeking over \$188 billion annually to finance project preparation efforts.⁹⁵

The USDFC could help increase the commercial viability and developmental impacts of projects by using its grants authority to provide technical assistance, training, or feasibility studies that support these projects. These activities would effectively enhance the pipeline of bankable infrastructure projects in developing countries.

COUNTRIES IN FRAGILE CONTEXTS WITH WEAK PRIVATE SECTORS AND SHALLOW FINANCIAL MARKETS

There is an increased political push for international development institutions to operate in low-income countries and, in particular, fragile and conflict-affected states (FCS) to help develop the private sector and attract higher amounts of private financing (see figure 4). The private sector not only provides jobs and services but acts as an important stabilizer for society by building markets, working with governments, and contributing to development through different social programs.⁹⁶ A well-functioning local private sector attracts more international investment and continues to provide economic growth beyond

90. "Global Infrastructure Outlook," Global Infrastructure Hub (GIH), <https://outlook.gihub.org/>.

91. Erin Nealer, *Barriers to Bankable Infrastructure* (Washington, DC: CSIS, 2016), <https://www.csis.org/analysis/barriers-bankable-infrastructure>.

92. The World Bank Group, *Procuring Infrastructure Public-Private Partnerships Report: Assessing Government Capability to Prepare, Procure, and Manage PPPs* (Washington, DC: The World Bank, 2018), <http://pubdocs.worldbank.org/en/256451522692645967/pdf/PIP3-2018.pdf>.

93. "Macroeconomic Risk," Global Risk Institute, <https://globalriskinstitute.org/research/macroeconomic-risk/>; New Climate Economy, *The Sustainable Infrastructure Imperative: Financing for Better Growth and Development* (Washington, DC: The Global Commission on the Economy and Climate, 2016), https://newclimateeconomy.report/2016/wp-content/uploads/sites/4/2014/08/NCE_2016Report.pdf; Frank Beckers and Uwe Stegemann, *A risk-management approach to a successful infrastructure project* (New York, NY: McKinsey & Company, 2013), <https://www.mckinsey.com/industries/capital-projects-and-infrastructure/our-insights/a-risk-management-approach-to-a-successful-infrastructure-project>.

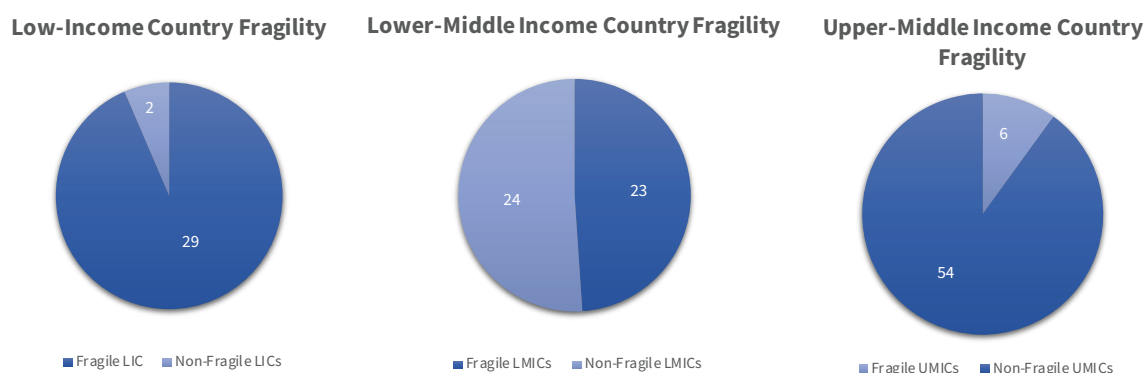
94. Fida Rana, "Preparing bankable infrastructure projects," *World Bank Blogs*, September 26, 2017, <http://blogs.worldbank.org/ppps/preparing-bankable-infrastructure-projects>.

95. GIH, *Leading Practices in Governmental Processes Facilitating Infrastructure Project Preparation* (Sydney, Australia: GIH, 2019), <https://www.gihub.org/resources/publications/leading-practices-in-governmental-processes-facilitating-infrastructure-project-preparation>. Per the same Global Infrastructure Hub report, the cost of project preparation is expected to be 5-12 percent of the total project value. This estimate of \$188 presumes a minimum of 5 percent being required for project preparation, although the actual cost of project preparation can be higher when higher-level policy preparations are absent.

96. International Finance Corporation, *Generating Private Investment in Fragile and Conflict-Affected Areas*, (Washington, DC: IFC, 2019), <https://www.ifc.org/wps/wcm/connect/07cb32dd-d775-4577-9d5f-d254c-c52b61a/201902-IFC-FCS-Study.pdf?MOD=AJPERES>.

DFI investments and foreign aid. These countries are characterized by governments that have weak capacity to ensure the proper functioning of political and market institutions. In extreme cases, they are trapped in a vicious cycle of poverty, conflict, and persistent fragility where weak and fractured states inhibit the private sector to grow—thus perpetuating poverty and social exclusion and fueling the next wave of violence.⁹⁷

Figure 4: Fragility and Country Income Categories, 2018



Sources: The Organization for Economic Co-Operation and Development (OECD), *States of Fragility 2018* (Paris, France: OECD, 2018), <http://www.oecd.org/dac/conflict-fragility-resilience/listofstateoffragilityreports.htm>; “Data,” The World Bank, <https://data.worldbank.org/>.

In these more difficult cases, studies show that it takes an average of six to seven years for significant private investments to materialize once the conflict is over.⁹⁸ Lee (2017) argues that post-conflict countries and fragile contexts require an even more differentiated approach to mobilizing private capital. Fragile states will require more than money: it will take a combination of diverse financing tools, advice, and development approaches to support these states. This will include supporting policy reforms, using grants and equity to jumpstart innovations, and greater collaboration among development partners to avoid overlap and waste. The IFC recommends being “flexible and patient” when approaching investments in fragile states as well as “developing deep, local knowledge; identifying good local investors and firms; developing knowledge about the political economy; and being ready to seize opportunities when they emerge.”⁹⁹

Companies doing business in fragile contexts consider lack of energy supply, transport infrastructure, access to finance, and low demand for products as key constraints to their operating environment. Moreover, other challenges such as institutional environment (judicial independence and enforcement of contracts), weak governance (corruption and customs procedures), unpredictable regulations, and political instability are more pronounced in fragile states versus other low-income countries. Given the high risks in these countries, DFIs working with MDBs and other donors are best suited to play a significant role and intervene in order to break this vicious cycle of fragility.¹⁰⁰ DFIs would support private sector projects while

97. Collier, Gregory, and Ragoussis, *Pioneering Firms in Fragile and Conflict-Affected States*.

98. Nancy Lee, *Billions to Trillions? Issues on the Role of Development Banks in Mobilizing Private Finance* (Washington, DC: Center for Global Development, 2017), <https://www.cgdev.org/publication/billions-trillions-issues-role-development-banks-mobilizing-private-finance#poor-and-fragile>.

99. International Finance Corporation, *Generating Private Investment in Fragile and Conflict-Affected Areas*.

100. Ibid.

other development partners could support the public sector capacity of those countries.

Through an FCS dedicated unit, the DFC could work with other DFIs and U.S. agencies to support three interrelated areas:

- **Experimenting, Building Knowledge, and Working with Partners:** Addressing fragility will require an approach that is comfortable with a degree of “experimentation”—that is, the DFC will need time to understand what works and what doesn’t, generate knowledge, and identify some of the most successful interventions so far. It will require greater collaboration among development partners to learn about different interventions and avoid overlap and waste.
- **Providing Financing**
 - In fragile contexts, the DFC could focus its efforts on projects that have the capacity to generate employment (for example, by targeting specific sectors) and that will foster greater social cohesion (for example, by increasing financial inclusion). In geographic areas that have potential for terrorism growth, the DFC should aim to steer youth towards a more positive path of skills training and employment. This could be complemented with infrastructure investments which provide employment and have a more lasting effect on economies.
 - The DFC could work with other DFIs to support pioneer firms and complementary investments in fragile states to create investment clusters. This can include subsidizing firms’ initial entry costs, providing direct equity to pioneering firms, and/or using political risk insurance and partial credit guarantees to mitigate various risks threatening investments into such pioneer firms.¹⁰¹
 - The DFC could work with other DFIs and MDBs to create new financing instruments specifically for engaging youth in fragile contexts.¹⁰² For example, the United States Institute of Peace (USIP) recommends a “partnership development fund” as a new platform to coordinate activities on conflict prevention that pools resources from donors and governments of fragile states to finance activities and investments.¹⁰³
- **Fostering Greater Social Inclusion**
 - Through its investments, the DFC can help build stronger economies and a more effective and long-lasting peace and security process in a country by supporting:
 - Women’s economic participation.
 - Sectors that have high employment potential.
 - Financial inclusion, targeting low income households and underserved SMEs (for example, through the use of loan portfolio guarantees).

101. Collier, Gregory, and Ragoussis, *Pioneering Firms in Fragile and Conflict-Affected States*; Kaushik Basu, *Fiscal Policy as an Instrument of Investment and Growth* (Washington, DC: The World Bank, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2431988.

102. Paul M. Bisca and Olivier Lavinal, “From Battlefields to Boardrooms A Development Approach to Fighting Violent Extremism,” in Erol K. Yayboke and Sundar R. Ramanujam (eds.), *Sharpening Our Efforts The Role of International Development in Countering Violent Extremism* (Washington, DC: CSIS, 2019), 18-26, https://csis-prod.s3.amazonaws.com/s3fs-public/publication/190701_RundeYaybokeRamanujam_CVEAnthology_WEB_v3.pdf.

103. USIP. 2019. Preventing Extremism in Fragile States: A New Approach. Washington DC. <https://www.usip.org/publications/2019/02/preventing-extremism-fragile-states-new-approach>.

Invest in Sectors with High Development Impact

When it comes to specific sectors, the DFC will have to evaluate the needs in each country it intends to invest in; U.S. comparative advantages vis-à-vis other development partners; and the likely impact in terms of jobs and economic growth, innovation (create new products or process), or social inclusion (target underserved sectors). As mentioned earlier, the DFC should not be spread too thin: it needs to focus on a narrow set of sectors where it can make investments to have greater impact.

Some of the strategic sectors identified through the research process where the DFC could make an impact are in infrastructure development, agribusiness, and financial inclusion/financial sector development. Projects supporting urban services and smart cities that demonstrate U.S. quality and values would also greatly increase U.S. visibility.

- **Infrastructure Development:** The DFC is not meant to compete with Chinese infrastructure development; however, it could be more active in this space (Box 6).¹⁰⁴ Access to internet and reliable power are still lacking in many regions of the world. Functioning ports and a network of roads are in high demand. These are high-risk projects and sensitive in nature but are not prohibited and will require environmental and social impact mitigation measures.¹⁰⁵ Prioritizing the development of energy infrastructure will be an effective way to promote the security interests of both the United States and its allies. The United States should consider expanding the Power Africa initiative to supplement the DFC's energy development efforts in all countries it operates in. This would be a relatively cheap way to finance energy infrastructure development in the countries that need it the most.

104. Matthew P. Goodman, Daniel F. Runde, Jonathan E. Hillman, and Erol Yayboke, *The Higher Road: Forging a U.S. Strategy for the Global Infrastructure Challenge* (Washington, DC: CSIS, 2019), https://csis-prod.s3.amazonaws.com/s3fs-public/publication/190423_Hadley%20et%20al_HigherRoads_report_WEB.pdf; Daniel F. Runde, Agnes Dasewicz, Todd Moss, and Kate Steel, *America's Global Infrastructure Opportunity: Three Recommendations to the New U.S. Development Finance Corporation* (Washington, DC: CSIS, 2019), https://csis-prod.s3.amazonaws.com/s3fs-public/publication/190410_Runde%20et%20al_DFC%20and%20Infrastructure_layout_v3.pdf.

105. OPIC, *Environmental and Social Policy Statement* (Washington, DC: OPIC, 2017), [https://www.opic.gov/sites/default/files/files/final%20revised%20ESPS%2001132017\(1\).pdf](https://www.opic.gov/sites/default/files/files/final%20revised%20ESPS%2001132017(1).pdf).

BOX 6: INFRASTRUCTURE INVESTMENTS AND THE DFC

CSIS recently authored a report entitled *The Higher Road: Forging a U.S. Strategy for the Global Infrastructure Challenge*¹⁰⁶ which highlights the following recommendations for the United States International Development Finance Corporation (DFC) in terms of infrastructure development abroad:

- The DFC should create and lead a Global Infrastructure Connectivity Fund. The new fund should bring together multilateral development banks and bilateral development finance institutions to adopt measures that incentivize commercial banks and pension and equity funds to invest in projects or provide project development assistance.
- The DFC should establish a Connectivity Compact that places countries who receive funds from the Global Infrastructure Connectivity Fund into the international system of quality infrastructure standards. USAID and other U.S. development agencies would then provide technical assistance to help these countries meet the required standards.
- The DFC should work to crowd-in private sector investors by allocating \$200 million for the Currency Exchange Fund (TCX), which assists in developing local capital markets and diminishing exchange risk for private sector sponsors. Financial instruments such as swaps and forward contracts give the TCX the power to allow investors to provide borrowers with financing in their own currency, a key driver of small and medium-sized enterprises' growth.

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- **Digital Technology and Enabling Smart Cities:** Estimates show urban areas across the globe will continue to grow rapidly over the next few decades, especially in developing countries. One area of prioritization for the United States in its global infrastructure investments should be the development of smart cities. These smart cities will be highly reliant on data analytics and advanced technology such as 5G networks to function properly. The DFC should consider prioritizing services such as governance and financial planning technical assistance in urbanizing areas of the developing world so that they will be capable of adopting the advanced technology as soon as it reaches their borders. The DFC can also offer loans, credit guarantees, and equity investments into data dashboards, security systems, trade facilitation advancement, data nerve centers, and water services—all of which are critical to smart cities infrastructure.¹⁰⁷

In addition, in the future the DFC could be called to support 5G infrastructure abroad in case a viable alternative to Huawei's 5G network infrastructure is found. A U.S. or Western firm that could compete with Huawei would be a game changer for the development finance and foreign policy spheres. The DFC must be ready to support a U.S. company (or ally) that offers an alternative approach to Huawei.

106. Goodman et al., *The Higher Road: Forging a U.S. Strategy for the Global Infrastructure Challenge*.

107. Runde et al., *America's Global Infrastructure Opportunity*.

- **Investing in Higher Added Value Agriculture:** Higher urbanization rates, growing middle classes, and an increase in population mean that more people will need to be fed. Additionally, an already existing and growing consumer class has changing tastes, and new technologies can be deployed to make food production more efficient and diverse. Associated services such as storage, food safety, marketing, packaging, and advertising are being deployed to entice consumers and offer them a greater variety of choices.

Although employment in agriculture has been declining, it still accounts for 63 percent of employment for low-income countries and 40 percent in lower-middle-income countries in 2018.¹⁰⁸ Yet these jobs are usually in the informal sector, and productivity remains low with many agricultural products lacking value-add. In 2017, the agricultural value-added per worker was lowest for countries in South Asia and sub-Saharan Africa, where the value-added was often less than \$1,000.¹⁰⁹ Many farmers still lack access to finance, which precludes them from buying the necessary equipment, land, or seeds to improve crop production, expansion, and diversification. Through its development finance tools, the DFC can help this underserved sector increase productivity and generate quality jobs.

- **Increasing Financial Inclusion:** Many people lack access to formal financial services, such as loans, money transfers, and savings. Fostering greater financial inclusion is essential for the sustained growth of an economy, allowing individuals to be connected to their formal financial systems and build assets or make investments, and enables the growth of micro, small, and medium enterprises (MSMEs). Since 2011, over 1.2 billion people have gained access to a financial account.¹¹⁰ However, in 2017, 1.7 billion adults remained unbanked, and in developing countries, only 63 percent had an account open at a financial institution.¹¹¹ The key hindrance to equal financial inclusion is weak digital infrastructure, which entails increased transaction and monitoring costs vis-à-vis disbursements of loans, and offsets the ability for banks, governments, or financial actors to provide solutions for unbanked individuals.¹¹² The DFC can assure greater financial inclusion for marginalized adults—mainly women in poor contexts and those living in rural areas—by improving digital and financial infrastructure and transparency in developing countries; encouraging legal and regulatory frameworks that level the playing field for unbanked adults; and providing loans, guarantees, and financial risk mitigation services to institutions in order to link unbanked adults with these services.¹¹³

108. "Employment in agriculture (% of total employment) (modeled ILO estimate)," The World Bank, <https://data.worldbank.org/indicator/SL.AGR.EMPL.ZS>.

109. Max Roser, "Employment in Agriculture," Our World in Data, 2019, <https://ourworldindata.org/employment-in-agriculture#agricultural-productivity>.

110. "Gains in Financial Inclusion, Gains for a Sustainable World," The World Bank, May 18, 2018, <https://www.worldbank.org/en/news/immersive-story/2018/05/18/gains-in-financial-inclusion-gains-for-a-sustainable-world>.

111. "The Global Findex database 2017: Measuring Financial Inclusion and the Fintech Revolution," The World Bank, <https://globalfindex.worldbank.org/>.

112. Sarah Murray, "How developing nations use tech to reach the 'underbanked,'" Financial Times, April 23, 2019, <https://www.ft.com/content/0c6ddd3c-4b36-11e9-bde6-79eaea5acb64>.

113. "Gains in Financial Inclusion, Gains for a Sustainable World," The World Bank.

Conclusions

When CSIS began this research project, we argued that the DFC as a new and modern institution would be better suited to support U.S. government endeavors in addressing three national security and foreign policy challenges: i) offering a better development model than China, ii) providing economic alternatives and support stabilization to counter violent extremism, and iii) addressing the root causes of migration via jobs and private sector development. The DFC can and should support these objectives, but it is also important to recognize that the DFC's role in these areas will be limited. Fostering economic growth and private sector development through the deployment of development finance is only one part of the response for countering violent extremism, China's rise, or migration flows.

The complexity of these issues will require concerted action from the security, diplomatic, and development communities. Addressing these challenges will also entail soliciting greater collaboration among DFIs and development institutions with host country governments. The primary responsibility for development falls on the countries themselves; however, multilateral and bilateral institutions play an important role in supporting these efforts, especially in countries where the institutional and governance structures are weak.

The DFC will only be able to help address these challenges in an indirect way by helping build strong private sectors abroad. It can do so by using its new financial toolbox more creatively, pursuing more innovative approaches to development, and partnering with other development players.

1. Where and how can the DFC counter the rise of China as a development player?

Much of the initial buzz surrounding the BUILD Act stemmed from the notion that the DFC would counter the rise of China in the developing world. While China has become a world development player, there is certainly an opportunity for the United States to offer an alternative development model through the DFC and its sister agencies.

The DFC can provide a more robust development alternative to China by focusing on SMEs and smart, quality infrastructure and through partnerships and coordination with other DFIs and U.S. agencies. To do so, the DFC should i) increase U.S. visibility by investing in projects where the United States has a comparative advantage; ii) pool

the financial resources and expertise of other DFIs to leverage more private capital; and iii) communicate its principles and intangible assets such as quality, transparency, and capacity building.

Some of the United States' visibility issues can be attributed to the perception that China invests in large-scale infrastructure projects which allow local politicians to take credit and "cut the ribbon," while the United States works in sectors that are less apparent to the public. To increase U.S. visibility in the developing world, the DFC should prioritize its investments into sectors where the United States possesses a comparative advantage, such as financial sector development, digital technology, agribusiness, and energy infrastructure. Prioritizing sectors such as energy infrastructure and urban services will be an effective way to promote the visibility and security interests of both the United States and its allies. While working with other development agencies, the DFC can use technical assistance to help mobilize local savings and scale up the use of loan portfolio guarantees to continue reaching underserved sectors that China is not interested in investing in. Smallholder farmers, women-owned businesses, and SMEs cannot access sources of financing or do so at unreasonable rates in most developing countries. Many local banks also shy away from long-term riskier endeavors such as infrastructure development, which provides an opportunity for the DFC to step in.

China has the money and labor required for projects to be completed expeditiously, but the DFC can leverage its partnerships with a cadre of other well-respected DFIs and other agencies from around the world to share expertise and coinvest on projects. For every dollar OPIC committed, the benchmark was to leverage two dollars in additional investments from other sources. Over time, the DFC will double OPIC's financing capabilities, which will enable the DFC to take greater risks and have a larger footprint if it pools resources with other partners. The DFC can potentially double its commitments from OPIC's current \$4 billion to \$8 billion, which is a good first step, but it remains limited compared to the \$10-\$15 billion per year that China's AIIB plans to lend.¹¹⁴ That does not mean the DFC or the United States should go dollar for dollar with China on infrastructure projects, but the DFC should focus on U.S. comparative advantages: invest in infrastructure projects that are developmentally sound and make financial sense and focus on supporting the creation of market-based economies by providing vitally needed finance.

Moreover, the United States offers intangible qualities which need to be better communicated and marketed. Transparency in procurement processes, free-market economic principles, technology and knowledge transfers, increased environmental safeguards, debt sustainability assessments, quality infrastructure standards, and a willingness to invest in SMEs are some of the distinct advantages of the U.S. development finance approach. U.S. companies competing for contracts might have higher costs in the short term, but through lower lifecycle costs and the benefits of U.S. technical training, it becomes clear the U.S. is the better partner in the long term.

114. Salvatore Babones, "China's AIIB Expected To Lend \$10-15B A Year, But Has Only Managed \$4.4B In 2 Years," *Forbes*, January 16, 2018, <https://www.forbes.com/sites/salvatorebabones/2018/01/16/chinas-aiib-expected-to-lend-10-15b-a-year-but-has-only-managed-4-4b-in-2-years/#5340230a37fl>.

These are unique features that the DFC needs to highlight vis-à-vis China's state-led development model. Making this strong case is critical for the DFC, other U.S. agencies, and allies to start winning more deals in countries where China is investing heavily.

2. Where and how can the DFC address the root causes of migration?

For many Americans along the U.S.-Mexico border, migration from the Northern Triangle is the most pressing challenge the DFC should aim to confront. Various iterations of a border wall and other measures to dissuade migrants from coming to the United States have been proposed by Congress and the Trump administration, but there is consensus amongst development experts that a lack of economic opportunities, social services, and widespread violence are the main factors driving people to leave their homes in search of a better life in the United States.

The primary goal for all stakeholders working in countries with large migration rates is to provide the necessary economic, social, and political conditions to prevent people from wanting to emigrate in the first place. This will be a long-run endeavor that will require the collaboration of a range of donors and host country governments. The impact that the DFC will have on deterring migration will be limited and indirect, either through job creation or developing infrastructure that can support long-run economic growth. Other challenges such as persistent violence and lack of security, gang warfare, human and drug trafficking, and other "push factors" for migration will require different interventions.

For the DFC to better support countries' development efforts, it should approach the Northern Triangle or other regions with large migratory populations with the help of other DFIs, development agencies, and U.S. partners. As it plans investments in these countries, it needs to target regions that are underdeveloped and underfunded and focus on sectors that can create jobs or better services, so people are enticed to stay in their countries of origin. The sectors will vary from country to country, but agro-processing and SME development are two candidates that were highlighted in our case studies. The travel and tourism industry also has the potential for mass employment, though this is an industry that is better served by pure commercial intermediaries rather than financing from DFIs.

One approach to address migration is for the DFC to invest in the development of secondary cities so that citizens have better opportunities than the ones offered by congested and overstretched capital cities. Secondary cities could provide thousands of new jobs for workers of all skill levels if the DFC invests in supporting urban infrastructure. People migrate to cities looking for better services: transport, health and education, sanitation, open spaces, entertainment, dining, and security. In this regard, investing in smart cities to supply modern urban services would be a unique value-add that U.S. technology can provide and would be a significant upgrade for city functions and citizen experiences.

3. Where and how can the DFC address the rise of violent extremism?

Perhaps the most difficult challenge for the DFC to address is the threat of violent extremism. Since the response to such a complex challenge cannot be solely circumscribed to development finance, addressing violent extremism will require a holistic approach

that brings together security, diplomatic, and development efforts.¹¹⁵ The groundbreaking joint UN-World Bank report *Pathways to Peace* concludes that the best way to prevent societies from descending into crisis is by making investments that foster inclusive and sustainable development. This includes addressing economic and social inequalities, making institutions more inclusive, and ensuring that strategies are risk-informed.¹¹⁶

While joblessness, economic exclusion, and youth idleness are contributors to the likelihood of youth joining extremist groups, other factors also play a role.¹¹⁷ Weak state and institutional capacity, political disenfranchisement, and upbringings plagued by war and gang violence play an equal, if not greater, role in the propensity for youth to join gangs and terrorist organizations. In other words, terrorism and violent extremism are not caused solely by poverty and joblessness, but these challenges make it easier for radicals to recruit foot soldiers in fragile contexts. Moreover, the nature of violent extremism is also changing as insurgents are no longer located exclusively in disenfranchised regions or rural areas. Many now live in urban areas among citizens, learning about local issues and using technology to spread their ideology. In 2017, half of the violent Islamist groups were operating outside conflict zones, gaining members from developed countries and fragile and failed states alike.¹¹⁸

As Michel (2018) describes, research shows the relationship between violence and other factors associated with societal fragility, such as the rule of law and political, social, and economic stability. High concentrations of violence are often found in poor communities and in countries with high-income inequality.¹¹⁹ Violence and conflict are concentrated in a few specific regions. Latin America and the Caribbean had 17 times more violence than East and Southeast Asia, while Arab countries accounted for more than two-thirds of the world's conflict-related deaths.¹²⁰

DFIs and the MDBs have little experience in countering violent extremism because this has not been part of their traditional *modus operandi*. However, this is a new policy area where MDBs, DFIs, and other donors are being asked to play a bigger role. According to Bisca and Lavinal (2019), the new frontier for development institutions will be to devise new financing tools and mechanisms to help counter fragility, conflict, and violence. These are precisely the places we see market failures and therefore need a helping hand, but where even the current risk-averse international DFIs shy away from.

115. Yayboke and Ramanujam (eds.), *Sharpening Our Efforts: The Role of International Development in Countering Violent Extremism*.

116. United Nations and World Bank, *Pathways for Peace: Inclusive Approaches to Preventing Violent Conflict* (Washington, DC: The World Bank, 2018), <https://openknowledge.worldbank.org/handle/10986/28337>.

117. Ibid.

118. Emman El-Badawy, "State and Society: The Importance of Maintaining the Social Compact When Addressing Violent Extremism," in Yayboke and Ramanujam, *Sharpening Our Efforts: The Role of International Development in Countering Violent Extremism*.

119. OECD, *States of Fragility 2016*, 43–46; United Nations, *The Sustainable Development Goals Report 2017* (New York, NY: United Nations, 2017), 50, <https://unstats.un.org/sdgs/files/report/2017/TheSustainableDevelopmentGoalsReport2017.pdf>. See Gary A. Haugen and Victor Boutros, *The Locust Effect: Why the End of Poverty Requires the End of Violence* (New York: Oxford University Press, 2014); Rachel Hart, *Analysis of Global Homicide Patterns* (Berkeley, CA: University of California, 2015), <https://www.econ.berkeley.edu/sites/default/files/HART-Honors%20Thesis.pdf>.

120. Michel, *Managing Fragility and Promoting Resilience to Advance Peace, Security, and Sustainable Development*.

Working in these places will require development institutions to take bold steps into uncharted territory and take smart risks. Preventing and containing violent extremism will require development interventions that support the work of peacebuilders and diplomats.

Given the complexity of the challenge, what are some concrete approaches that the DFC could undertake?

- **Experimenting, Building Knowledge, and Working with Partners**

- Addressing violent extremism is certainly uncharted territory for the DFC. Therefore, this challenge will require an approach that is comfortable with a degree of “experimentation”—that is, the DFC will need time to understand what works and what doesn’t, generate knowledge about the root causes of violent extremism, and identify some of the most successful interventions so far. It will require greater collaboration among development partners to learn about different interventions and avoid overlap and waste.

- **Providing Financing**

- In fragile contexts, the DFC could focus its efforts on projects that have the capacity to generate employment (for example, by targeting specific sectors) and that will foster greater social cohesion (for example, by increasing financial inclusion). In geographic areas that have potential for terrorism growth, the DFC should aim to steer youth towards a more positive path of skills training and employment. This could be complemented with infrastructure investments which provide employment but have a more lasting effect on economies.
- The DFC could work with other DFIs to support pioneer firms and complementary investments in fragile states to create investment clusters. This can include subsidizing firms’ initial entry costs, providing direct equity to pioneering firms, and/or using political risk insurance and partial credit guarantees to mitigate various risks threatening investments into such pioneer firms.¹²¹
- The DFC could work with other DFIs and MDBs to create new financing instruments specifically for youth in fragile contexts.¹²² For example, the USIP recommends a “partnership development fund” as a new platform to coordinate activities on conflict prevention that pools resources from donors and governments of fragile states to finance activities and investments.

- **Fostering Greater Social Inclusion**

- Through its investments, the DFC can help build stronger economies and a more effective and long-lasting peace and security process in a country by supporting:
 - Women’s economic participation.
 - Sectors that have high employment potential.
 - Financial inclusion, targeting low income households and underserved SMEs (for example, through the use of loan portfolio guarantees).

121. Collier, Gregory, and Ragoussis, *Pioneering Firms in Fragile and Conflict-Affected States*; Basu, *Fiscal Policy as an Instrument of Investment and Growth*.

122. Paul M. Bisca and Olivier Lavinal, “From Battlefields to Boardrooms: A Development Approach to Fighting Violent Extremism,” in Yayboke and Ramanujam, *Sharpening Our Efforts The Role of International Development in Countering Violent Extremism*.

There are several limitations as to what the DFC can accomplish, and expectations need to be managed. The DFC is not the equivalent to China's Belt and Road Initiative, it will not be able to double its operations in the first years, and it should not be regarded as a substitute for foreign aid. Alone, the DFC will not be able to tackle all these foreign policy challenges.

This is an important time for the development finance community with the new DFC starting operations. It is a chance for the DFC to collaborate with ally DFIs in transactions, operations, and policy-related work. DFIs can expand their impact by leveraging their capital to crowd in private investors if they work together to mobilize private finance from coinvestors through loan syndications, coinvestments, and other mechanisms. If the DFC is willing to lead a coalition of like-minded MDBs, DFIs, and U.S. agencies, a more robust private sector will be fostered abroad, and major development challenges can be more effectively addressed.

About the Authors

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Previously, Mr. Runde held senior leadership roles at the International Finance Corporation (IFC). From 2005 to 2007, he was director of the Office of Global Development Alliances (GDA) at the U.S. Agency for International Development (USAID), and he led the GDA partnership initiative by providing training, networks, staff, funds, and advice to establish and strengthen public-private partnerships. His efforts at USAID leveraged \$4.8 billion through 100 direct alliances and 300 others through training and technical assistance.

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Annex A: Country Case Studies

CSIS chose the Philippines, Tunisia, and Guatemala as case studies to provide a series of lessons learned for future programs by the United States International Development Finance Corporation (DFC). These countries are representative of the major U.S. geostrategic issues of China's rise as a development player, violent extremism, and forced migration. In choosing the countries, CSIS sought to balance representation in different regions and varied economic structures and development status (two are lower middle income—the Philippines and Tunisia—while one is a fragile, upper-middle-income country—Guatemala). These case studies have been published as separate papers.

In each country, CSIS met with government officials, executives from businesses, directors of aid agencies, high-level staff at U.S. embassies, security actors, bilateral development finance institutions (DFIs) and multilateral development bank (MDB) representatives (the Asian Development Bank [ADB], the Inter-American Development Bank [IADB], the African Development Bank [AfDB], and the World Bank), chambers of commerce members, and think tanks. CSIS also interviewed counterparts of the DFC, such as Japanese, Korean, and German stakeholders in both the private and public sector, to hear their perspectives.

During the first half of 2019, CSIS interviewed 80 stakeholders in those three countries (31 in Tunisia, 22 in the Philippines, and 27 in Guatemala) as well as 15 experts from DFIs and other development agencies. CSIS also undertook an extensive desk review that utilized the publications listed in Annex C.

The following questions were asked in all three countries:

- What are some areas that you think the new DFC will be able to pursue in collaboration with other development finance institutions (DFIs)?
- What concrete joint projects or products should be pursued? What new products or approaches would you like the new DFC to undertake?
- If you have ever collaborated with the Overseas Private Investment Corporation (OPIC), what were the main barriers hindering the process?
- How can the DFC leverage the work of the other U.S. development agencies (OPIC, Millennium Challenge Corporation [MCC], Export-Import Bank of the United States [EXIM], U.S. Agency for International Development [USAID])?
- What types of new financing instruments are needed?

- Do you see a role for the new DFC in working with impact investors?
- What do you foresee as the DFC's main limitations?
- What three key technologies will have the most impact in achieving the Sustainable Development Goals?
- How can DFIs accelerate and enable the adoption of key technologies in developing countries?
- How have DFIs in the past supported telecommunications infrastructure development (e.g., cellphones)?
- With new technologies like big data or 5G wireless communication entering the markets, how can DFIs be more strategic about the risks they pose to society?

The Philippines exemplifies a developing country where the contested security and economic forces of China and the United States are present. Its location in the South China Sea makes it an attractive area of investment for U.S. and Chinese firms. The Philippines case study was meant to inform the DFC on the tools, technical assistance programs, and sectoral approaches that Southeast Asian countries need but China cannot offer. Questions to stakeholders in the Philippines included:

- What strengths do you identify in the U.S. approach (government programs, private sector) compared to China's? What are the U.S. weaknesses?
- What are some areas that you think the new DFC will be able to pursue in collaboration with other DFIs on the ground? (e.g., infrastructure? Small and medium-sized enterprise [SME] development? entrepreneurship?)
- How should the DFC approach infrastructure financing?
- What tools and approaches are most needed in the Philippines? Southeast Asia?
- How can the DFC collaborate with the government of the Philippines and its other partners to engage youth and counter violent extremism? What are the most promising economic sectors to engage youth?

Tunisia is a good example of the Middle East and North Africa (MENA) region's challenges, which include weak private sectors, youth disengagement from the workforce, and the potential for violent extremism. The youth unemployment rate in Tunisia has not dipped below 30 percent since 2010. Even youth that are highly educated (tertiary level) struggle with unemployment levels over 60 percent because of the low demand for highly skilled labor in Tunisia. These high levels of unemployment have led to as many as 6,000 suspected Tunisian youth joining violent extremist groups in recent years.¹²³ The Tunisia case study aimed to guide the DFC on how it can collaborate and work with allies and other DFIs, specifically in economic sectors that can engage youth. Questions to stakeholders in Tunisia included:

- What should be the DFC approach to private sector development in Tunisia?
- What tools and approaches are most needed in Tunisia? North Africa?

123. Counter Extremism Project, "Tunisia: Extremism & Counter-Extremism," (New York, NY: 2019), Counter Extremism Project, https://www.counterextremism.com/sites/default/files/country_pdf/TN-07252019.pdf.

- What are the most promising economic sectors to engage youth?
- How can the DFC collaborate with the government of Tunisia and other partners on the ground to engage youth and counter violent extremism?

With close to 17 million people, Guatemala is a good representation of the problems in the Northern Triangle—particularly the perennial challenge of migration that stems from a lack of jobs and internal security. The challenges in the Northern Triangle will likely last for the next 20 years and will continue to impact U.S. national security. Countries in the Northern Triangle face a significant gang and criminal activity problem that magnifies a lack of economic opportunity as gangs find recruits among the region’s unemployed or underemployed. Although there is less overall gang violence in Guatemala, Guatemalans migrate mostly to the United States because of extreme poverty, especially among its very large indigenous community. The Guatemala case study strived to inform the DFC strategy on the specific tools and approaches that are needed to develop the private sector in ways that mitigate economic migration. Questions to stakeholders in Guatemala included:

- What are the most successful approaches and financing instruments to develop the private sector in Guatemala? What are the main challenges? What should be the DFC’s role?
- Which promising industries or sectors should the DFC focus on in order to trigger economic growth and employment?
- How can the DFC leverage the work of other U.S. government programs in combatting the root causes of migration?
- How can the DFC collaborate with the government of Guatemala and other partners on the ground to provide better alternatives to migration?

Annex B: A Brief Description of U.S. Development Agencies

The **United States Agency for International Development (USAID)**, created in 1962, is one of the world's largest and oldest official aid agencies. USAID serves to carry out U.S. foreign policy and contribute to U.S. interests while improving lives, reducing poverty, and promoting self-reliance in the developing world.¹²⁴ The international development agency provides humanitarian assistance for disaster relief and human well-being, contributes technical and financial assistance to encourage partner countries' development independent of aid, and catalyzes private enterprises and partnerships to improve investment outcomes both abroad and in the U.S. private sector. In 2018, USAID spent \$20 billion, contributing to projects and operations in 139 countries, mainly in Asia and Africa.¹²⁵ The sectors with the most funding were Emergency Response and HIV/AIDS. In the past 15 years, USAID has also made great progress in the effectiveness of its partnerships, leveraging \$16 billion in public and private funds not from the U.S. government.¹²⁶

The **Millennium Challenge Corporation (MCC)** is an agency created in 2004 focused on creating economic growth in poor but relatively well-governed countries by creating incentive for change and focusing on a country's constraints to growth. As one of the U.S. government's most effective soft power tools, it provides grants to high-performing countries (i.e., governments with solid governance track records) and arranges programs to primarily be driven by the locally defined needs.¹²⁷ For a variety of reasons, including absorptive capacity of the partner countries, the MCC never became the transformative, \$5 billion per year agency that President George W. Bush first envisioned 15 years ago,¹²⁸ but with a budget of \$800-900 million per year, the MCC has been able to make \$11 billion in growth-focused investments, mainly in infrastructure, with close to 70 percent taking place in Africa.¹²⁹ The MCC is a global leader for development agencies in transparency and sets the standard for monitoring and evaluation of its programs.

124. "What We Do," USAID, <https://www.usaid.gov/what-we-do>.

125. "Dollars to Results: USAID investments and illustrative results," USAID, <https://results.usaid.gov/results>.

126. USAID, *Agency Financial Report Fiscal Year 2018* (Washington, DC: USAID, 2018), https://www.usaid.gov/sites/default/files/documents/1868/USAIDFY2018AFR_508R.pdf.

127. "About MCC," MCC, <https://www.mcc.gov/about>.

128. John Norris, "President Bush and His Development Legacy," *Devex*, July 5, 2016, <https://www.devex.com/news/president-bush-andhis-development-legacy-87725>.

129. "Congressional Budget Justification, FY 2018: Executive Summary," MCC, <https://www.mcc.gov/resources/story/story-cbj-fy2018-executive-summary>.

The **United States Trade and Development Agency (USTDA)** is a small, independent federal agency that seeks to link U.S. businesses to export opportunities in developing countries with the goal of creating U.S. jobs and improving the export of U.S. goods and services for development projects in emerging economies. Established in 1992, the organization works with the private sector in the early, preparation stage of a public works or other development project to highlight areas where quality U.S. expertise and technologies can be most effectively catalyzed. USTDA focuses on leveraging the U.S. private sector in targeting the transport, energy, and telecommunications sectors in middle-income and low-income countries by offering feasibility studies, technical assistance, and reverse trade missions. Since its inception, it has generated over \$61 billion in U.S. exports and supported over 500,000 American jobs. In 2017, for each \$1 invested by the agency, the agency claims \$95 were generated by American exports.¹³⁰

The U.S. Department of Agriculture's **Foreign Agricultural Service (FAS)** is the USDA foreign export branch, serving to link U.S. agriculture to export opportunities around the globe in order to support U.S. farmers as well as global food security. The FAS utilizes agricultural attaches and locally hired agricultural experts in 93 offices covering 171 countries to provide on the ground, practical solutions in order to advance U.S. agricultural interests.¹³¹ In FY 2019, U.S. agricultural exports were forecast at \$137 billion, emphasizing the need for an organization such as the FAS to efficiently connect U.S. farmers to export opportunities.¹³²

The **Small Business Administration (SBA)**, created in 1953, helps grow American small businesses by providing aid, counsel, and assistance in order to protect competitive enterprises and the interests of small businesses.¹³³ In FY 2018, the SBA approved more than 66,000 loans and 504 loan programs, serving to provide over \$30 billion to small businesses while supporting 600,000 jobs.¹³⁴

The **Export-Import Bank of the United States (EXIM)** has been the U.S. export credit agency since 1934, serving to help U.S. exporters obtain financing in difficult country contexts by covering the credit and country risks that the private sector is unable or unwilling to accept.¹³⁵ U.S. exporters thus benefit mainly from the following financing tools EXIM provides: protecting exporters against nonpayment risk by foreign customers; offering support for U.S. companies selling services overseas; backing exporters' loans from private banks to finance materials and labor; and providing financing to foreign buyers for project, transportation, and U.S. export sales financing.¹³⁶ Since 2009, the bank has returned nearly \$3.8 billion to the U.S. Treasury and supported 1.4 million private-sector U.S. jobs.¹³⁷ The majority of EXIM's transactions in 2016 were to U.S. small businesses.¹³⁸

130. Daniel F. Runde, Romina Bandura, and Brunilda Kosta, *What is the U.S. Trade and Development Agency?* (Washington, DC: CSIS, 2018), https://csis-prod.s3.amazonaws.com/s3fs-public/publication/180130_Runde_USTDA_Web.pdf?OP9tthkFui9w3W0UBeIvEQAAmLiUo4gB.

131. "About FAS," USDA Foreign Agricultural Service, <https://www.fas.usda.gov/about-fas>.

132. Kamron Daugherty and Hui Jiang, *Outlook for U.S. Agricultural Trade* (Washington, DC: USDA, 2019), <https://downloads.usda.library.cornell.edu/usda-esmis/files/6m311p28w/cz30q344x/vq27zx69t/AES108.pdf>.

133. "Organization," SBA, <https://www.sba.gov/about-sba/organization>.

134. SBA, *Agency Financial Report Fiscal Year 2018* (Washington, DC: SBA, 2018), <https://www.sba.gov/sites/default/files/2018-11/SBA%20FY%202018%20AFR.pdf>.

135. "History of EXIM," EXIM, <https://www.exim.gov/about/history-0>.

136. EXIM, *Export Finance Solutions to Increase Sales for U.S. Businesses* (Washington, DC: EXIM, 2016), https://www.exim.gov/sites/default/files/managed-documents/EXIM-Brochure_NOV2016-inhouse.pdf.

137. EXIM, *Fiscal Year 2016 Annual Report* (Washington, DC: EXIM, 2017), <https://www.exim.gov/sites/default/files/reports/annual/EXIM-2016-Annual-Report.pdf>.

138. "About Us," EXIM, <https://www.exim.gov/about/facts-about-ex-im-bank>.

Annex C: CSIS Relevant Research on the Topic

Publications on the DFC

- *Sharing Risk in a World of Dangers and Opportunities* by Daniel F. Runde, Ashley Chandler, Terry Wyer, Conor M. Savoy, and Thomas Patterson (December 2011)
- *Development Finance Institutions Come of Age* by Conor M. Savoy, Paddy Carter, and Alberto Lemma (October 2016)
- “We Shouldn’t Be Eliminating OPIC, We Should be Putting it On Steroids” by Daniel F. Runde (April 5, 2017)
- “Statement Before the House Foreign Affairs Committee Subcommittee on Asia and the Pacific—Development Finance in Asia”—a testimony by Daniel F. Runde (November 15, 2017)
- “DFIs Drive the Development Agenda to Center Stage” by Daniel F. Runde and Christopher Metzger (December 6, 2017)
- “Rethinking Private Capital for Development” by Romina Bandura (December 2017)
- “Opinion: The New US DFI deserves the development community’s support. Here’s why” by Conor Savoy (March 9, 2018)
- “Statement Before the Senate Committee on Foreign Relations—Modernizing Development Finance”—a testimony by Daniel F. Runde (May 10, 2018)
- “The BUILD Act Has Passed: What’s Next?” by Daniel F. Runde and Romina Bandura (October 12, 2018)
- *Renewing U.S. Economic Engagement with the Developing World* by Daniel F. Runde, Romina Bandura, and Owen Murphy (November 2018)
- *Blended Finance and Aligning Private Investment with Global Development* by Conor M. Savoy and Aaron Milner (March 27, 2018)
- “Development Finance Institutions: Plateaued Growth, Increasing Need” by Daniel F. Runde and Aaron Milner (February 13, 2019)
- “America’s Global Infrastructure Opportunity: Three Recommendations to the New U.S. Development Finance Corporation” by Daniel F. Runde, Agnes Dasewicz, Todd Moss, and Kate Steel (April 11, 2019)

Publications on Related Geostrategic Challenges

- *Global Infrastructure Development: A Strategic Approach to U.S. Leadership* by Daniel F. Runde, Conor M. Savoy, and Charles F. Rice (March 2016)
- *Achieving Growth and Security in the Northern Triangle of Central America* by Daniel F. Runde, Christina Perkins, and Erin Nealer (December 2016)
- *China's Maritime Silk Road* by Zack Cooper et al. (March 2018)
- *Confronting the Global Forced Migration Crisis* by Daniel F. Runde, Erol K. Yayboke, and Aaron N. Milner (May 2018)
- "Opinion: Time to build a (virtual) wall addressing the root causes of forced migration" by Daniel F. Runde (August 2018)
- *Financing and Implementing the Quality Infrastructure Agenda* by Daniel F. Runde and Sundar R. Ramanujam (September 2018)
- *The Higher Road: Forging a U.S. Strategy for the Global Infrastructure Challenge* by Matthew P. Goodman, Daniel F. Runde, Jonathan E. Hillman, and Erol Yayboke (April 23, 2019)
- *How 5G Will Shape Innovation and Security* by James Andrew Lewis (December 6, 2018)
- *Sharpening Our Efforts: The Role of International Development in Countering Violent Extremism* by Erol Yayboke and Sundar R. Ramanujam (June 28, 2019)
- *Investment Facilitation in Transitional and Fragile States* by Jake Cusack and Matt Tilleard (December 16, 2013)
- *The World of Work in Developing Countries* by Romina Bandura and MacKenzie Hammond (October 19, 2018)
- *U.S. Economic Engagement in Africa: Making Prosper Africa a Reality* by Daniel F. Runde and Romina Bandura (April 26, 2019)
- *A New Social Contract for the Northern Triangle* by Daniel F. Runde and Mark L. Schneider (May 8, 2019)
- *A Demand-Driven Approach to Development* by Daniel F. Runde, Romina Bandura, and MacKenzie Hammond (May 15, 2019)

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