The Takeaway

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Equity in Development Finance:

Strengthening U.S. Economic Diplomacy

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Development finance is one of the most important tools in the U.S. economic diplomacy toolkit. Economic Diplomacy advances U.S. interests by promoting economic growth abroad, creating stronger trade partners, and fostering political relationships. Countries supported through U.S. development finance are more likely to purchase U.S. exports and maintain positive, cooperative ties with the United States. However, in many developing countries local financial markets fail to function in ways that efficiently allocate resources or reward entrepreneurship, leading to high risk aversion and a gap between the supply of, and demand for local investment. Meanwhile, the United States relies much less on equity finance than the rest of the world, but it would experience considerable benefits from expanding equity finance in particular and development finance in general. Thus, this takeaway presents the role development finance plays in U.S. economic diplomacy, how development finance is implemented around the world, and the important role that equity finance plays in development finance.

DEVELOPMENT FINANCE AND U.S. ECONOMIC DIPLOMACY

Development finance plays an important role in economic diplomacy because financial markets are critical for economic growth. It carries long-term implications for economic growth, and although the rela-

WHAT'S THE TAKEAWAY?

Development finance is an important tool for U.S. economic diplomacy, as it opens markets, and maximizing its capabilities is essential to counter global competition.

Development finance supports innovation and benefits SMEs in developing countries, when domestic financial investors hesitate due to high risks.

Equity provides excellent advantages over traditional finance by increasing communication, support, leverage, and risk mitigation.

The United States should prioritize equity investments within its development finance strategy, given the recent shift away from traditional aid models.

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tionship between international financial flows and growth in developing countries depends on capital flow type, macroeconomic context, and absorptive capacity, the literature shows that finance is key to growth, especially in low- and middle-income countries. Simply promoting capital flows is not enough. One of the main types of financial flows is the Foreign Direct Investment (FDI), and while it contributes to growth, supporting local initiatives by supporting local financial markets might be more important for per-capita GDP growth.[1] Other studies show that FDI yields negative short-term but positive long-term impacts on growth in developing and emerging markets, but the conditions to make FDI productive, such as human capital, infrastructure, and healthy domestic financial markets, are often lacking in developing countries. [2]

Healthy domestic financial markets sustain long-run growth by allocating capital efficiently.[3] Having other institutions in place, such as sufficient and efficient protection of property rights, further amplifies the benefits of financial development. In fact, Hamdi, Hakimi, and Sbia show that strong institutions enhance financial development's positive effect on growth across 100 developing and 43 developed nations.[4]

Since these conditions are often lacking in many developing countries, development finance emerged as an important tool of economic diplomacy. The United States entered the development finance world with the creation of the Overseas Private Investment Corporation (OPIC) in 1971. As an independent agency in the Federal Government, OPIC had three tools: direct loans and loan guarantees, political risk insurance, and seed capital for private equity funds. Although these tools for development finance were adequate for the basic needs of development finance in the decades that followed inception, they were not sufficient to compete effectively in the 21st century, particularly as China embarked upon its Belt and Road Initiative. That prompted an effort in Congress to update and modernize the U.S. Government's development finance capability by creating the U.S. International Development Finance Corporation (DFC) and giving it a variety of new tools including the authority to make direct equity investments.

Box 1: Brief History of the U.S. International Development Finance Corporation

The U.S. International Development Finance Corporation (DFC) was launched in 2019 under the Better Utilization of Investments Leading to Development (BUILD) Act of 2018. It merged the functions of the Overseas Private Investment Corporation (OPIC), which had provided political risk insurance and debt financing since 1971, and the Development Credit Authority (DCA) from USAID, which specialized in loan guarantees.

Unlike its predecessor agencies, the DFC can take equity positions in projects and companies, doubled the U.S. government's development finance ceiling to $60 billion, and gained the ability to offer local-currency loans, provide technical assistance, and operate in higher-income countries when doing so serves U.S. foreign policy goals.

These changes created a modernized U.S. development finance institution with a broader toolkit—allowing it to better compete with other state-backed lenders and to focus on sectors such as renewable energy, critical infrastructure, healthcare, and technology that advance both development and strategic objectives.

Maximizing the capabilities of the DFC is essential for competing in a global environment where other nations—particularly China—use development finance to advance strategic influence.[5] Building on U.S. strengths such as transparency, the rule of law, and market-driven practices can help distinguish American development finance from state-directed lending models and strengthen its appeal to partner countries.

Ensuring that the DFC operates effectively from its earliest years requires robust internal systems and processes.[6] Priorities include integrating USAID's Development Credit Authority staff, developing strong capacity to assess development impact, forming dedicated deal teams to manage projects, and maintaining public reporting of outcomes. These measures are critical for sustaining credibility, attracting co-investment, and achieving both development and strategic policy goals.

HOW DEVELOPMENT FINANCE IS IMPLEMENTED AROUND THE WORLD

Development finance plays a significant role in the economic diplomacy strategies of many governments and institutions because it offers the opportunity for special kinds of guidance and support that are not available through other instruments, like tariffs or food aid. Since finance supports capitalism by providing capital for innovation and expansion, particularly in risky and vulnerable economies, it promotes sustained growth (teaching others how to fish rather than just sending fish). Many national and multilateral development banks include project requirements or preferences for other policy goals, such as green or sustainable development. According to P. Dvorak from the European Bank for Reconstruction and Development (EBRD) (personal communication, July 10, 2025), development finance allows businesses to achieve commercial returns without sacrificing development impact, such as adopting green methods.

Development finance enables early-stage, highly innovative companies and enterprises in risky or vulnerable locations to receive financing. These companies are the engines of growth in every capitalist economy. Such financing might include loans or debt, equity financing, or venture capital. Development finance can target startup ventures, SMEs, and other activities unlikely to receive traditional financing due to high risk. In economies with low investment and funding, development finance provides opportunities, especially for SMEs, which risk-averse domestic banks or incomplete financial markets often overlook.

Dvorak teaches us that one goal of investing in insecure enterprises or vulnerable locations is to pave the way for future investments. While many traditional banks and investors hesitate to invest in similar portfolios, development finance can make them profitable, encouraging other entrepreneurs and fund managers to replicate the model. This can create a positive feedback loop, attract more investors, and accelerate growth—much like venture capital's impact on Romania's robotic process automation sector.

HOW EQUITY INCREASES THE EFFECTIVENESS OF DEVELOPMENT FINANCE

The choice between financing through loans and the acquisition of debt or financing through the acquisition of equity has significant implications for economic stability and growth. For example, East Asia's experience illustrates equity's value. Equity markets supplied pivotal capital for industrial expansion and innovation, complementing traditional banking systems and spreading risk while enhancing capital allocation decisions.[7] Furthermore, debt financing can lead to over-leveraging and potential financial crises; equity participation allows for risk-sharing and can enhance financial stability.[8] Alternative financing mechanisms not only provide necessary funding to emerging enterprises but also contribute to improvements in governance and strategic guidance.[9]

According to J. Hall of the Asian Development Bank (ADB) (personal communication, June 30, 2025), "Equity is central to ADB's strategy, unlocking private sector growth, deepening capital markets, and supporting inclusive development. It offers patient capital for long-term value creation especially where finance is limited or innovation requires risk tolerance." Hall also noted, "Private equity offers several advantages in development work, including the ability to provide long-term, patient capital that supports high-impact projects in underserved sectors and regions. It can drive innovation, improve corporate governance, and attract additional private investment by de-risking opportunities."

According to Dvorak, financial sustainability goes both ways with equity investment. For many startup companies, there may not be anything to use as collateral to finance the project through debt alone. For many early companies and SMEs,

"Equity is central to ADB's strategy, unlocking private sector growth, deepening capital markets, and supporting inclusive development. It offers patient capital for long-term value creation especially where finance is limited or innovation requires risk tolerance."

equity is an instrument for them to finance what needs to be financed, particularly for enterprises where there is limited availability of banks or the unwillingness of conservative banks.

According to P. Singhal of the EBRD (personal communication, July 15, 2025), equity investment allows financiers to "sit with the company and understand exactly what they do and how the investment will be used; one has the ability to build a value creation plan, sit on the board and supervisory board, and have a say in the allocation of funds." The main lesson is that equity provides excellent advantages over traditional finance by increasing communication, support, leverage, and risk mitigation.

CONCLUSION

Equity investment strengthens development finance by expanding institutional investment capacity, enabling governance oversight, and mobilizing private capital. Given the recent shift away from traditional aid models, the United States should prioritize equity investments within its development finance strategy. The DFC's expanded mandate, combined with strategic insights, offers a roadmap for building a more agile, competitive, and impactful U.S. development finance system.

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Notes:

[1] *Ahmad, E., & Malik, A. (2009). Financial sector development and economic growth: An empirical analysis of developing countries. Journal of Economic Cooperation and Development, 30(1), 17–40.*

[2] *Dinh, T. T.-H., Vo, D. H., The Vo, A., & Nguyen, T. C. (2019). Foreign direct investment and economic growth in the short run and long run: Empirical evidence from developing countries. Journal of Risk and Financial Management, 12(4), 176. https://doi.org/10.3390/jrfm12040176*

[3] *Mhadhbi, K., Terzi, C., & Bouchrika, A. (2020). Banking sector development and economic growth in developing countries: A bootstrap panel Granger causality analysis. Empirical Economics, 58(6), 2817–2836. https://doi.org/10.1007/s00181-019-01670-z*

[4] *Hamdi, H., Hakimi, A., & Sbia, R. (2017). Finance–growth nexus: What role for institutions in developed and developing countries? Journal of Economic Development, 42(4), 1–22. https://doi.org/10.35866/caujed.2017.42.4.001*

[5] *Mosbacher, R. (2025, February 16). The US must play to its strengths to compete with China in Latin America. Financial Times. https://www.ft.com/content/fc196f5c-d20c-4a55-a2a0-8ad77c4f0b49*

[6] *Mosbacher, R. (2020, January 14). What the US International Development Finance Corporation needs to do in its first year. Devex. https://www.devex.com/news/what-the-us-international-development-finance-corporation-needs-to-do-in-year-1-96352*

[7] *McCulloch, R., & Petri, P. A. (1998). Equity financing of East Asian development. In M. Kahler (Ed.), Capital flows and financial crises (pp. 158–185). Cornell University Press.*

[8] *Lächler, U. (1990). Debt versus equity participation in development finance. World Development, 18(1), 39–49. https://doi.org/10.1016/0305-750X(90)90108-U.*

[9] *Breuer, W., & Pinkwart, A. (2018). Venture capital and private equity finance as key determinants of economic development. Journal of Business Economics, 88(3–4), 319–324. https://doi.org/10.1007/s11573-017-0872-4*

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