



Working Paper

What can development finance institutions learn from new growth theories?

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Key messages

As shareholders push development finance institutions (DFIs) to focus more on investing in places where there is little private sector growth, there has been increased interest in how to create markets and the firms that operate within them. DFI strategies are evolving beyond support for the growth of individual firms and the demonstration effect this may produce, to promoting change at the level of markets and industries.

Mainstream neoclassical economics underpins most economic analysis in DFIs, with a focus on capital accumulation, decreasing returns, competition, price distortions and market failures. It is ill-equipped to explain dynamic change which DFIs seek to promote. But here is a growing literature of new growth theories that explains growth processes at the level of markets and industries.

The fundamental insight is that it is not the quantity of capital that DFIs provide that matters, but how their actions help to change markets. This shifts the role of DFIs from financing investible opportunities in markets as they are today, to fostering market development to create investible opportunities tomorrow (which may or may not require DFI financing). It changes the way that DFIs assess markets, towards a focus on standards, contestability, entry and exit and path dependency. It changes the way DFIs select investments, towards a focus on clusters of investments, favoring urban, FDI and trade-intensive projects, favoring challenges over incumbents, and taking more of a venture capital approach of backing good firms rather than good projects, while taking lower probability bets with higher payoffs. It changes the way DFIs approach blended finance, towards a focus on generating knowledge rather than correcting market failures.

None of this sits easily with traditional project credit risk analysis, or traditional market analysis, so DFIs need to rethink their approach to selecting investments if they want to operationalise these insights.

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Abbreviations and acronyms

AFIC	Africa Forestry Investment Company
AIMM	Anticipated Impact Measurement and Monitoring
BII	British International Investment
CEPR	Centre for Economic Policy Research
DFI	Development Finance Institution
EBRD	European Bank for Reconstruction and Development
ESG	Environmental, Social and Governance
EU	European Union
FDI	Foreign Direct Investment
FERDI	Fondation pour les Études et Recherches sur le Développement International
G20	Group of Twenty
GEMS	Global Emerging Markets (DFI loan database)
HIPSO	Harmonized Indicators for Private Sector Operations
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IFI	International Financial Institution
IFN	Research Institute of Industrial Economics (Stockholm)
IP	Intellectual Property
JV	Joint Venture
MDB	Multilateral Development Bank
MIT	Massachusetts Institute of Technology
NBER	National Bureau of Economic Research
OECD	Organisation for Economic Co-operation and Development
R&D	Research and Development
SDG	Sustainable Development Goal
SME	Small and Medium-sized Enterprise
VC	Venture Capital
WBG	World Bank Group

Introduction

Ideas, institutions, population and human capital are now at the center of growth theory. Physical capital has been pushed to the periphery (Romer, 2009).

This quotation from Paul Romer, one of the pioneers of endogenous growth theory, poses a challenge to development finance institutions (DFIs). If ‘ideas, institutions, population and human capital’ is what matters, what role can DFIs¹ – whose primary function is to finance physical capital investments – play?

This question is relevant to current discussions among shareholders and management of DFIs on future operational and investment strategies. Key stakeholders see a critical role for private enterprise and investment in achieving the Sustainable Development Goals (SDGs) and tackling climate change (Brookings Institution, 2023), and so are asking DFIs to do more (G20, 2023; G20 Independent Experts Group, 2023) – and in some cases have recapitalised them so that they can expand their operations (e.g. IFC’s 2018 capital increase; IDB Invest’s 2024 capital increase; EBRD’s 2026 capital increase). At the same time, many DFIs have been criticised for their limited ability to catalyse private sector growth in fragile and low-income economies (Attridge and Gouett, 2021; Kenny, 2021). Several have responded by giving more strategic priority to ‘upstream’ activities to develop markets and pipelines of investible projects (e.g. IFC’s Creating Markets strategy (International Finance Corporation, 2020; Le Houerou and Lankes, 2023)). There has been growing willingness among donors to provide concessional funds to DFIs to enable them to push the boundaries of what they are able to do on commercial terms (often referred to as ‘blended concessional finance’). All this raises strategic and operational questions about what DFIs should do to promote private sector growth more effectively.

Endogenous growth theory and related Schumpeterian growth theories (collectively, New Growth Theories) grew out of

¹ In 1956, the World Bank established an affiliate to invest in commercial firms in developing countries – the International Finance Corporation (IFC). Since then, many other multilateral and bilateral DFIs have been created – more than 20 in Europe alone – with similar mandates to promote economic and social development by investing equity and/or debt in firms (mostly privately owned) operating in developing countries. We use the term ‘DFI’ to encompass both bilateral DFIs and the private finance affiliates and programmes of Multilateral Development Banks.

dissatisfaction with the ability of previous growth theories to explain growth which involves technical change and structural transformation. While neoclassical and Keynesian growth models can explain a lot of the catch-up growth that occurred in many low- and middle-income countries over the past 70 years, they have little to say about the lack of growth in some, or why growth sometimes stalls in middle-income countries.² Nor do they have much to say about how growth occurs in a context of rapid technological and structural change.

The purpose of this paper is not to weigh in on the debate on the validity of competing growth models, but rather to identify insights from new growth theories for DFIs, whose business strategies – explicitly or implicitly – are based on a theory of how the private sector in low and middle income countries grows. I hope these insights will stimulate fresh thinking amongst the management and shareholders of DFIs on how these institutions can be more effective in promoting private sector development.

² The 2024 World Development Report on growth challenges in middle-income countries draws extensively on new growth theories (World Bank, 2024).

The (implicit) growth theories underpinning development finance

The intellectual framework that guided the creation of most DFIs has reflected that of the international financial institutions (IFIs) in general. Drawing on simple “two-gap” fixed-price, fixed-technology models of development, development finance originally aimed to fill the gap in the availability of foreign exchange (Chenery & A.Strout, 1966). Hence, IFC’s early investments (from the 1950s to the 1970s) mainly financed foreign direct investment into low and middle income countries. Over time, neoclassical ideas – known as the “Washington consensus” - came to dominate IFI thinking, with their emphasis on markets finding an equilibrium through flexible prices (Easterly W. , 2001). These ideas see market outcomes as depending on the starting conditions of factor endowments (capital, labor, land, technology) and the political institutions which enable markets to function (laws, regulations, macro-stability). They recognize that market failures and missing markets may prevent markets from achieving optimal outcomes, but suggest that the response should be to correct those market failures to move towards more complete markets which internalize all costs and benefits (either through taxes/subsidies or through regulations) (Yusuf, 2009). This requires removal of impediments to market functioning and strengthening the institutional framework for markets (see (Acemoglu, Introduction to modern economic growth, 2009) for a description of neoclassical growth theory).

According to neoclassical growth models, adding more capital – like adding other factors of production – would generate growth, but with diminishing returns – over time growth would return to a pace determined by (exogeneous) technical change. Capital scarcity in low-income countries implied that the marginal rate of return on investment would be high, so absent market failures, capital would flow from high- to low-income economies, enabling catch-up growth. Lucas (1988) exemplified this perspective when he declared the observed failure of capital to flow from capital-abundant high-income economies to capital-scarce low-income economies to be one of the greatest puzzles in economics.

The development agenda that emerges from this emphasises the role of governments (and their development partners) in increasing the supply of factor endowments, correcting market failures (through regulations, taxes and subsidies) and strengthening the political institutions that support markets (courts, regulations etc.) (Commission on Growth and Development, 2008). This agenda was perhaps most visible in the World Bank's long-running flagship report on private sector development, *Doing Business*. These reports focused on the legal and regulatory framework that enables or impedes the operations of SMEs. Although the developers of these reports would dispute this interpretation,³ the attention that the WBG and other DFIs give to the benchmarks tracked in these reports creates the impression that all that is needed for SMEs to flourish is to improve regulatory processes and reduce the burdens on firms that they measure. But, as many countries that were top reformers on the *Doing Business* indicators found, improvements on their own may not lead to significant changes in SME activity.

In this model, private firms pursue opportunities created by the prevailing investment climate and factor availability, pursuing competitive advantage based on a country's comparative advantage. This suggests that, if the conditions for markets are in place, then they should form spontaneously. The role for DFIs is to finance the opportunities that become available, where private financing is not available (due to financial market failures). This implies that what DFIs should do is search for investment opportunities which simply lack capital to proceed. These opportunities could come from domestic as well as foreign firms. This describes well the day-to-day operations of many DFIs.

The drawback of neoclassical growth theory is that it leaves the sources of sustained growth exogenous: it is better at describing the path towards a stable equilibrium – where factors are put into production, using available technology, and income levels and investment rates of return converge – than describing processes which move an economy to a higher equilibrium. It says a lot about getting the conditions right for private investment – static performance – but doesn't say much about how growth actually gets going and continues – dynamic performance. It describes allocative efficiency but not adaptive efficiency (North, 1990). This is particularly problematic for DFIs, whose mandate is to move economies away from low-level equilibria towards greater dynamism and change.

Neoclassical growth theory explains catch-up growth well – and this growth has been an important driver of poverty reduction and improved conditions of life across the world. But it does not provide a good framework for analysing middle-income country growth – how to avoid the middle-income growth trap when catch-up growth has been exhausted. Nor does it provide a good framework for

³ I led the *Doing Business* report through three editions (2009–2011).

understanding how fragile and conflict-affected economies can get their economies moving. A 2001 review of the evidence found that factor accumulation only explained a small share of growth in developing economies (Easterly and Levine, 2001).

Over the past 30-plus years, new theories have emerged that provide endogenous explanations of economic growth, and describe dynamic processes by which markets change (Aghion and Howitt, 1998). While the extent to which they improve on neoclassical theories in describing growth at a macro level may still be a matter of academic debate, at a microeconomic level they provide new insights into how markets change. This is important for DFIs because strategies based on neoclassical growth models have been found wanting.

In the countries where catch-up growth has been sustained over extended periods, such as China and Vietnam, there has been little need for external actors like DFIs to play a significant role, and growth has been rapid even in mediocre (or worse) investment environments. The need for external support for private investment has mainly been in those countries stuck in low levels of economic activity, or where catch-up growth has been insufficient to lead to structural transformation (Collier, 2007). DFIs typically focus their investments in these countries, with mixed results. Here the insights from neoclassical growth theory have proved to be of limited use. Efforts to improve the investment climate (such as through reforms) have achieved disappointing results in increasing private investment and growth. Efforts to increase the supply of capital have foundered on a lack of investible opportunities in slow-growth countries. Hence, China and India score poorly on investment climate indicators, yet have been the fastest-growing large countries over the past 20 years. Rwanda has an OECD standard investment climate, but private sector growth remains low (Banerjee and Duflo, 2019).

This disconnect between the operational prescriptions of neoclassical growth models and actual experience is reflected in the history of IFC, the largest multilateral DFI. IFC's investments evolved from financing FDI towards financing domestic and foreign firms, with an emphasis on finding investible firms unable to attract capital in the market on reasonable terms. IFC complemented this with advisory work to improve the investment climate and the performance of the financial sector and capital markets, to provide financing to firms on better terms. But IFC has done best financially where it has invested in imperfect but improving business environments, not in markets with the best investment climate – i.e. the dynamic is more important than the static for generating returns (Cole et al., 2020). More recently, IFC has given more attention to the need to create markets through its investment and advisory work, and to take a more holistic view of private sector growth opportunities through private sector diagnostic studies conducted jointly with the World Bank. However, the first round of these diagnostics focused on identifying constraints in the investment climate and policies that need to be relieved, rather

than identifying dynamic growth processes to be enabled and supported.

As shareholders push DFIs to focus more on the hardest places to invest, it becomes more important to understand growth trajectories not well captured by neoclassical growth theory. In these places, there are not enough investible opportunities, and DFIs struggle to meet investment targets. Meanwhile, rapid technological change poses new questions about viable growth paths for private enterprise in low- and middle-income economies (Hallward-Driemeier & Nayyar, 2017) (Rodrik, 2024). New growth theories offer the most relevant set of ideas about how markets change and develop in the light of changing technologies. They can therefore provide insights into what DFIs should do.

What is different about new growth theories?

We draw here on insights from the endogenous and Schumpeterian growth theory literature pioneered by Paul Romer, Philippe Aghion, Peter Howitt and others.⁴ Box 1 summarises some key distinctions between the insights from neoclassical and new growth theories on the drivers of economic growth.

Box 1 Key drivers of economic growth in neoclassical and new growth theories

Neoclassical vs New Growth Theory*	
Neoclassical: • Factor accumulation: land, labor, capital. Invest in quality improvements (eg human capital) • Market functioning: perfect competition. Larger markets better. Free entry/exit • Supportive government: property rights, regulation, macro stability • Firms: static efficiency optimization: low cost producer, optimal technology	New Growth Theory (NGT): • Knowledge accumulation: new technologies, spillovers, excludability/rent capture • Market functioning: monopolistic competition, free entry/exit, creative destruction, economies of scale, firm dynamics, risk capital • Supportive government: R&D, education, IP/tax regimes allow rent appropriation, human capital, openness to new ideas/ways of working, macro stability/low interest rates • Geography: clusters/cities/networks • Path dependency/lock-in
*included common themes from Endogenous Growth Theory, Schumpeterian Growth Theory etc	

We can identify five dimensions where the findings of new growth theories differ from neoclassical growth theory:

- 1 Factor accumulation versus knowledge accumulation.** In neoclassical theories, technology is an exogeneous given, and growth stems from applying more inputs (factors of production) to

⁴ See for example Aghion and Howitt (1998); Romer (1990); Hausman and Rodrik (2003); Aghion and Howitt (1998); Aghion, Howitt and Bursztyn (2008); Acemoglu and Robinson (2012); Acemoglu (2009); Aghion, Antonin and Bunel (2021); Aghion, Akcigit and Howitt (2013); Aghion (2016); (Jones & Romer, 2010).

the given production function. New growth theories bring technological change into the model (hence endogenous growth), and propose theories of how technological change happens, increasing Total Factor Productivity. Importantly, technological change both starts from, and creates, non-perfect markets – in a neoclassical market equilibrium with no possibility of capturing rents (excess profits), there is no payoff to innovation. New growth theories highlight the importance of temporary market power – e.g. through patenting – in generating rents that provide the payoff to innovation. They also emphasise externalities and public good aspects to knowledge creation. Knowledge – such as a new technology – is inherently non-rival in consumption (your use of an idea does not conflict with my use of it) and may lead to increasing returns as more users adopt it. Hence, the accumulation of knowledge is seen as driving market change (Jones & Romer, 2010).

- 2 **Market structure.** Neoclassical economics focuses on static allocative efficiency. Competitive markets with lots of producers are efficient in allocating resources. New growth theories focus on dynamic efficiency – what market structures will produce growth and market change over time. It finds that markets which confer some market power, through partial excludability, or economies of scale which favour the emergence of a few dominant firms, are more dynamic than perfectly competitive markets with lots of producers. But this is qualified by the need to avoid monopolies becoming entrenched. They therefore emphasise the importance of market ‘contestability’ by new entrants, and the facilitation of exit as well as entry, as the periodic turnover of dominant firms is dynamically efficient (Schumpeter’s ‘creative destruction’ (Schumpeter, *Capitalism, Socialism and Democracy*)). They also emphasise the importance of market opportunity (dynamic change) relative to the investment climate (static). Empirical analysis by the World Bank supports this view of what drives private investment (Hornberger, Battat and Kusek, 2011).
- 3 **Role of government.** In addition to the institutions and investment climate necessary for markets to operate, new growth theories emphasise the institutions and incentives needed for research and development and for firms to invest in new ideas. This includes intellectual property regimes and tax policies that reward R&D and innovation, investments in human capital and fundamental research by governments, and insolvency regimes that limit the cost of failure (Mazzucato, 2013). It also emphasises the importance of an iterative approach to industrial policy, with governments adapting policies in the light of private enterprise responses (Juhasz, Lane and Rodrik, 2023).
- 4 **Geography.** Neoclassical growth theory doesn’t have much to say about location. New growth theories emphasise the importance of clustering to facilitate knowledge spillovers, the role of cities as hubs for innovation (Jacobs, 1984), and the

importance of production networks in transferring technology and knowledge. These are increasingly recognised as key drivers of economic development (World Bank, 2009).

- 5 **Trade.** Neoclassical theories lead to trade strategies that maximise allocative efficiency through specialising according to comparative advantage. New growth theories emphasise the dynamic efficiency of participating in global value chains where countries can benefit from knowledge and technology spillovers (Hausman et al., 2014). This implies a role for government policy in steering trade towards more knowledge-intensive sectors and more knowledge-intensive activities in the value chain (e.g. from primary commodity production to processing) (Grossman and Helpman, 1991; Young, 1991). This insight solves a paradox for neoclassical economics in looking at Asian economic growth after the Second World War. The fast growth of Asian economies was grounded, not in their trading based on initial comparative advantage (agricultural products), but on entering global production chains for more complex products. Governments intervened to create production capacity in more knowledge-intensive industries, and then leveraged the knowledge thereby acquired (Hausman and Rodrik, 2003). FDI was brought in to sectors and under conditions that fostered technology transfer and knowledge acquisition.
- 6 **Path dependency.** In neoclassical growth models, time is not important – factors can be combined and recombined in different ways in response to market signals. In new growth theories, path dependency and lock-in feature strongly – the first mover reaps economies of scale and may be able to dominate a market, preventing later innovators from entering.
- 7 **Networks and platforms.** Increasing returns from knowledge and technology can create network effects, where all users benefit from being on a common network. Hence, the first platform to reach a critical mass of users will crowd out others. This can be valuable in creating common platforms on which other firms can compete. For example, Alibaba dominates ecommerce payments and logistics in China (a near-monopoly), but provides a platform for thousands of SMEs to sell goods (near-perfect competition).

Implications for DFIs

What are the implications for DFIs whose core competence is financing physical capital accumulation? The main implication is that it is not the quantity of capital that DFIs invest that matters, but how it is deployed to change markets. DFIs' role shifts from financing investible opportunities in markets, as they are today, to fostering market development to create investible opportunities tomorrow. Those opportunities may or may not require DFI financing. We can describe the appropriate DFI activities at three levels:

- 1 The development outcomes they are trying to achieve.
- 2 The strategic focus of their operations.
- 3 The projects they choose to support.

Development outcomes

Global value chains. New growth theories provide a different lens to think about the gains from trade and foreign investment (Gollin and Kaboski, 2024). Neoclassical trade theory focuses on welfare gains from lowering (static) production costs by specialisation according to comparative advantage and trade to match production to consumption. Foreign investment is seen primarily through its financial contribution, with FDI mainly driven by exploitation of resources (minerals, abundant labour etc.), which offer potential comparative advantage.

In contrast, new growth theories focus on the value acquired through integration into global value chains, either through trade or foreign investment. Of primary value is the acquisition of technology and knowledge through these chains. Trade brings firms into contact with other firms from whom they can learn and acquire technology. Foreign firms embed technology and knowledge in their operations. According to new growth models, the dynamic benefits from acquiring knowledge outweigh the static benefits of maximising comparative advantage. So a primary development outcome would be greater integration into global value chains, as a proxy for greater acquisition of technology and knowledge.

Research and Development. A key insight from new growth theories is that firms in competitive markets will under-invest in R&D. This is rational because the gains from innovation would quickly be competed away, while the innovator is left covering the fixed costs of

R&D. Weak IP regimes and enforcement in low-income countries further constrain the ability to earn a return on investments in R&D. Hence, there is a ‘second-mover advantage’ to adopting innovations by others, rather than innovating. This is particularly sub-optimal for low-income countries: most technological innovation takes place in higher-income economies, where the economic context is very different, and technological solutions may not be well adapted to low-income country contexts (Rodrik, 2016). For example, time- and labour-saving innovations (e.g. self-driving cars, meal delivery) may be suited to high-income economies, where labour is scarce and the opportunity cost of time is high, but it may not make economic sense to adopt these technologies in low-income economies where the value of labour time-saving is much less. Thus, DFIs will want to promote market developments that enable R&D by firms in low-income countries that is better suited to their relative factor costs. This includes stronger IP regulations with better enforcement, and encouragement of patents and temporary monopolies as rewards to innovation.

Entry and exit. Schumpeter extolled the virtues of ‘creative destruction’ whereby new entrants push existing firms out of the market. This churn results in higher productivity, with more innovative firms replacing less productive ones. This requires low-friction processes for firm establishment and market entry, and for firm dissolution (often through bankruptcy) and market exit (World Bank, 2005). The 2024 World Development Report discusses the challenges of promoting ‘creative destruction’ in middle-income countries in the face of resistance from incumbent firms with market power (World Bank, 2024). Hence, DFIs should support regulatory reforms that ease the costs and complexity of firm registration and bankruptcy. They should also promote the development of an ecosystem supportive of new venture creation – including business skills training, incubators and VC funds. They should support ‘challenger’ firms entering markets to compete with incumbents, and discourage governments from supporting existing firms on the grounds of ‘protecting jobs’.

Capital market development. A corollary of firm entry and exit is that capital must flow to new firms in order for market creation and creative destruction to occur. Hence, DFIs should support capital market development which makes it easier for incumbent firms to return capital to shareholders, and new firms to raise capital.

Clusters. Knowledge spillovers work better when there is physical proximity among knowledge users. Tacit knowledge can be acquired through the movement of managers and workers. Firms can share certain fixed costs, whether directly related to R&D – e.g. supporting a local university – or unrelated – e.g. sharing infrastructure. Sharing unrelated fixed costs helps reduce the overall burden, making it easier to bear R&D costs. Clusters are also better able to exploit economies of scale that extend beyond the individual firm or even

industry. For example, firms in export processing zones across diverse industries may all benefit from the ability of their collective trading activity to support a large, deepwater port. So DFIs should promote the creation of Special Economic Zones, industrial parks, incubators, growth poles and other forms of clustering of production, both within and across industries that can benefit from sharing fixed costs and from economies of scale in related activities. Belchin et al. (2019) provide examples of how sectoral coordination supports industry growth in a range of African countries. At its most general level, this means support for urbanisation and well-ordered cities, which provide a platform for clustering many knowledge-intensive service activities, rather than support for rural development.

Firm capacity. Firms vary in their management and staff capacity to create and deploy knowledge to improve products and operations. DFIs will want to build capacity in firms to better generate and use knowledge.

Inter-firm and inter-national connectivity. Since there are positive spillovers from improved transmission of knowledge, DFIs will want to promote transmission channels. At the firm level, this can include supporting M&A, joint ventures and partnerships, supporting the creation of value chains, and encouraging cross-firm collaboration on R&D. At the country level, DFIs could support knowledge exchange among policy-makers, regulators, trainers and others who facilitate market development.

Operations

If these are the development outcomes that DFIs seek to promote, how should they go about selecting which firms and markets to support, and how? New growth theories can also inform their own operational practices.

Dynamic vs. static efficiency. New growth theories suggest that dynamic efficiency (investing to secure tomorrow's market position) is more important than static efficiency (investing for the most advantageous position in today's market). This is challenging for the analysis of the credit risk of DFI investments – it is easier to evaluate credit risk based on today's market than on the potential market of tomorrow. Hence, the least risky investment is in today's market leader. A focus on dynamic efficiency will direct credit analysis towards an understanding of the contestability of the investee firm's market position, and its ability to sustain its market position in the face of responses by other firms. A focus on dynamic efficiency also suggests that investments will be most profitable, as well as most impactful, when they support firms that are improving their market position, rather than firms with the best market position today. It supports investments in challengers over incumbents, except where incumbents are innovating to stay ahead. It also suggests that returns and impact will be better when DFIs invest in markets that are

improving, rather than those that are already functioning well (in line with IFC's experience (Cole et al., 2020)).

Some DFIs financing private investment have adopted a dynamic view of the impact of their investments that reflects the concepts of new growth theories. From its inception in 1991, EBRD saw its role as supporting the transition from centrally planned to market economies, so market development was central to its impact assessment. This was formalised in its Transition Impact assessments. In 2016 EBRD updated its definition of Transition Impact to focus on progress towards desirable attributes of well-functioning market economies: competition, good governance, resilience, integration, inclusion and sustainability. The focus on assessing the impact of investment projects on overall market functioning is consistent with a focus on growth dynamics. Drawing on EBRD's experience, as well as new growth theories,⁵ in 2018 IFC updated its development impact framework, moving from a focus on project-level impacts to a combined focus on both project-level and market-level impacts, the Anticipated Impact Measurement and Monitoring (AIMM) system. This was underpinned by sector-specific frameworks that analysed the conditions for dynamic growth, as a basis for assessing the contribution of investments to market development (International Finance Corporation, 2020; Le Houerou and Lankes, 2023). These assessments are challenging, and it is hard to assess how reliable they are, but they ask the right questions.

Market analysis. An investment opportunity can only be understood in the context of the dynamics of its market, so DFIs should base their investment decisions on an analysis of how the market is likely to change tomorrow, not how it is today. This involves considering potential market responses to the entry or expansion of the firm the DFI is investing in, and the scope for the firm to earn rents for a period before they are competed away. This is built into the Transition Impact assessment system of EBRD and the AIMM impact assessment system of IFC.

Flying geese vs. herding cats. Just as East Asian high growth episodes have been analysed as sequences of growth across multiple countries (so-called 'flying geese'), so too can DFIs support inter-related markets as they change over time. New growth theories suggest that DFIs should take path dependency seriously. This means that country and market diagnostics (such as first-generation World Bank Group Country Private Sector Diagnostics introduced in 2018) that focus on comparing current performance with some notional optimum, and then propose an agenda to remove as many constraints as possible to move countries and markets towards that optimum ('herding cats'), will not provide a useful guide to action.

⁵ The design of AIMM was led by Hans Peter Lankes under the direction of CEO Philippe Houerou, who had both joined IFC from EBRD and brought their experience with Transition Impact with them. Coincidentally, Paul Romer was Chief Economist of the World Bank at the time, but was not closely involved in the design of AIMM. I was part of the design team, and undertook a literature review on growth theories to inform its design.

Instead, diagnostics should focus on where a country's private sector activity is today, and where it can go from there. This means abandoning the search for a single 'best' path for development, and allowing diverse paths to emerge from sequential market disruptions. It also suggests that attempts to diagnose future growth opportunities based on fundamentals of comparative advantage are misguided – investments will be more successful where they build momentum in sectors actually on the move, rather than investing in sectors theoretically ripe for development. Second-generation World Bank Country Private Sector Diagnostics introduced in 2025 are taking this more targeted approach (World Bank Group, 2025).

Strangers bearing gifts. The importance of knowledge spillovers and technology transfer should bias DFIs towards supporting FDI, cross-border ventures and other forms of inter-firm partnerships as vehicles for this. In a way, this is a return to the past for institutions like IFC and BII, which started out almost exclusively financing FDI before shifting focus to local firms (Gregory, Wagle and Weigel, 1997). DFIs should prefer FDI which involves local JV partners, trains local managers and connects to local value chains (enhancing knowledge transfer) over enclave investments and 100% foreign-owned and -managed FDI.

Bright lights. The importance of cities as vectors of knowledge (Jacobs, 1984) means that DFIs should support well-managed urban development, including support for the infrastructure and public services needed for cities to work well. EBRD's extensive financing of municipalities is an example of this approach. So too are investments by MDBs and DFIs into Special Economic Zones, where they are well-designed to support the growth of industry clusters (and not just provide infrastructure and tax advantages for warehousing and other entrepot activities). DFIs should also undertake bundles of investment and advisory activities which support the creation of industry clusters, growth poles, special economic zones and the like. However, few DFIs have the scale to be able to do this on their own. Hence, coordination mechanisms such as Country Platforms that can facilitate such clustering can be helpful. Collaboration between IFC and bilateral DFIs in Ethiopia to support industrialisation is an example of this (Ngoma, 2025). Conversely, DFIs should be sceptical of investments in rural areas and one-off investments in a sector, which are unlikely to contribute to dynamic growth.

Standards. New growth theories highlight the importance of common standards in reducing costs for individual firms and facilitating market competition, and so promote growth. However, they also demonstrate how markets can get locked in to standards that emerge first, whether they are optimal or not. This suggests that DFIs should pay special attention to their role in promoting good standards in the markets they invest in, including in regard to ESG and supply chains. DFIs can play an outsized role in development by leveraging their expertise, cross-country experience and honest broker status in this

respect. For example, IFC's ESG Performance Standards have been adopted by nearly 100 project finance banks to ensure consistent good management of ESG risks in major investment projects. DFIs can also support their clients to align with regional and global standards, such as EU food safety standards and global standards for sustainable forestry. The importance of standards as a foundation for economic development is explored in detail in the latest World Development Report (World Bank, 2025).

Innovation. Given the importance of innovation, DFIs should focus on investing in new technologies and business models rather than proven ones. Again, this creates challenges for credit risk screening, which favours investments with low technology and business model risk. It requires greater use of equity (to match volatile cashflows of innovation and to capture the upside reward on successes to offset the losses on failures), and a VC approach to investing – starting with multiple small bets, and continuing to finance those that show promise through successive financing rounds, while providing value additions to the firm. Such an approach is easier to implement when DFIs are monitored and evaluated on overall portfolio performance, rather than project by project. Traditionally, DFI boards approve individual projects, and DFI M&E functions look at individual project results, aiming for a high proportion of successful projects. This tends to stifle the ability to invest in multiple innovative projects, only a few of which may pay off. If venture capitalists were assessed on their 'hit rate' of profitable investments, they would be seen as poorly performing – but the one in 10 investments that succeeds may cover the losses of the nine investments that failed and still generate an attractive return. One way DFIs can overcome the mismatch between their institutional structure and the discipline of investing in innovation is by investing in third-party venture capital funds. IFC's technology sector investments have included a mix of direct investments and investments in VC funds. In 2016 IFC created the Start-Up Catalyst programme to support start-ups. To date, it has invested in 25 seed capital funds and venture incubators.

Inter-DFI collaboration. DFIs themselves can also benefit from knowledge spillovers and the sharing of fixed costs. There is value in collaboration in the development of new products, standards and approaches, and in gathering market intelligence and country diagnostics. From a static efficiency perspective, one DFI could attain some competitive advantage in being better or faster in these areas than another. However, from a dynamic perspective they may benefit more from reducing the fixed costs of research and development by sharing country diagnostics, market analysis and new product development. Examples include common ESG standards (based on IFC's Performance Standards), common loan documentation (more than 30 institutions use IFC's Master Cooperation Agreement), common principles (e.g. the DFI Principles for Blended Concessional Finance) and common impact metrics (the Harmonized Indicators for Private Sector Operations (HIPSO)). Country Platforms are the latest

attempt to coordinate MDB and DFI activities in specific countries, with local leadership.

Project selection

At the level of project selection, new growth theories suggest the following differences from traditional DFI practice:

Concentration. Standard portfolio theory says that, where investment success has low correlation across projects, a diversified portfolio will perform better in aggregate than a concentrated one. So DFIs commonly set limits on multiple investments in the same country and sector. Moreover, boards and shareholders have a bias towards projects seen as innovative and pioneering, as they are regarded as more likely to be ‘additional’ to what could get financed without the DFI. However, new growth theories highlight the positive spillovers that occur within markets and across firms, increasing the returns where multiple investments are made in the same market or the same value chain. This suggests that DFIs will do better where they focus resources on multiple related projects which reinforce each other and grow the overall market, compared to unrelated investments in different markets. Complementary investments by multiple DFIs can help achieve this while managing concentration risk. This approach also shares the fixed research costs of understanding a market or industry across multiple investments. BII has followed this approach in creating platform companies in key sectors and regions, such as power generation (Globelec) and forestry (AFIC) in Africa, which can invest in multiple subsidiary companies in the target sector/region (Gregory et al., 2025). EBRD has been more willing than many DFIs to do repeat deals and cluster investments because of the market transition lens it brings to project selection. IFC is moving towards more programmatic approaches in key sectors.

Into the unknown, with the right team. new growth theories show that the performance of markets and technologies cannot be fully identified in advance – investing is participating in a process of discovery, not in the implementation of a plan. Firms pivot and adapt as they learn – hence the importance of backing the right team, not the right plan. A portfolio approach is needed, not to diversify risks across unrelated markets, but to place bets on multiple options in the same market. Project evaluation (ex ante and ex post) needs to take this approach into account: by intent, not all investments will succeed, and without the failures there will be no successes. Evaluation approaches (such as the World Bank Group’s Independent Evaluation Group) which judge success on the proportion of investments which succeed are using the wrong benchmark. The aim should not be to maximise the proportion of investments that succeed, but to maximise the overall improvement in outcomes at the market level. Success at the market level may require some firms to fail. Those failures may still contribute to overall

market success. For example, IFC invested in standalone leasing firms in many countries in the 1990s. They introduced leasing products to new markets. Once introduced, domestic banks entered the market; with a lower funding cost than leasing firms, they often took over the market and drove the standalone firms out. Does that mean that the DFI investments in the leasing firms failed? No: from a market development perspective, they succeeded in introducing the new product. Since DFIs still have to earn a profit on their investments, it is important that they invest in a range of firms to capture a share of the successes to offset the costs of the failures. In this example, IFC investments in commercial banks often made profits which offset the losses from leasing companies. Again, it is easier to capture the upside by investing in equity or quasi-equity products.

Risk-taking. From a static perspective, project failure in frontier markets is overdetermined, and project success is underexplained. There are so many constraints and imperfections that it is easy to envisage how investments could fail. The market and government imperfections in China and India have been extensively documented, but these economies have grown at rates of 6–10% over long periods of time. A focus on market imperfections leads to risk-averse investment decisions, resulting in slow portfolio growth and lack of impact. DFIs that do this rarely lose their shirt, but they miss out on investment opportunities and fail to achieve their full potential. New growth theories support greater risk-taking, partly because of the learning effects of undertaking a risky investment. But the risk-taking is informed by dynamic analysis of how the market could develop, and by an investment approach that focuses on supporting the development of the market through multiple interventions, thereby reducing the risk of failure at the market level.

Spillovers. DFIs have a mandate to add value to their investee companies beyond what other private investors can provide – this is termed their additionality. In markets where capital is freely available, this additionality is often derived from the knowledge and standards that the DFI brings to its investments. This additionality has a public good dimension – by pioneering investments in new markets and difficult places, the DFI creates knowledge of risks or market conditions that can benefit other investors, who may later invest based on this knowledge (Collier, Gregory and Ragoussis, 2019). DFIs typically call these ‘demonstration effects’. Knowledge spillovers can be increased by systematically sharing information about how projects have performed. The GEMS database of DFI loan default rates is a modest step in this direction and has already begun to change investor perceptions of the risk of default on EM loans. But there is much more that DFIs could share on a comparable basis about their operations, while protecting commercial confidentiality. The importance of generating these spillovers can provide a rationale for subsidising the cost of DFI finance (‘blended finance’) in markets where DFIs struggle to cover their fixed costs through investment

returns, such as the most challenging frontier markets in fragile and conflict-affected states. This rationale for subsidy is temporary and differs from the neoclassical rationale for permanent subsidy based on market imperfections and externalities.

Table 1 DFI strategies informed by new growth theories – what changes?

Out	In
Market development strategy	
Move towards competitive market equilibrium	Exploit market disequilibrium, path dependence
Promote competition	Promote contestability
Work within existing market standards	Promote good market standards
Avoid monopolies	Exploit temporary market power/rents
Analyse market as it is today	Analyse market as it could be tomorrow
Investment selection	
Look at projects in isolation	Look at inter-related projects
Invest where investment climate is good	Invest where investment climate is improving
Invest in incumbents	Invest in challengers
Private equity/debt approach (high probability/low payoff to success)	Venture Capital approach (low probability/high payoff to success)
Minimise subsidies	Use subsidies strategically to develop markets
Diversify investment portfolio	Cluster investments for greater impact
Back good projects	Back good management teams
Invest in proven business models	Invest in innovative business models
Balance urban and rural investments	Favour urban investments
Balance local and foreign investment	Favour investments which increase FDI, trade

Concluding remarks

Shifts in intellectual frameworks often happen slowly, and sometimes unconsciously (Keynes, 1936). Most managers in DFIs could not explain how their investment strategies are based on neoclassical theories of economic growth. Since its first articulation in the 1990s, new growth theories have offered new insights into market development, without fully displacing the neoclassical view. We have attempted to show that these new insights are particularly relevant for DFIs, since they are charged with promoting change (development) in markets, rather than optimising the efficiency of existing markets. New growth theories offer a rich framework for thinking about how markets change.

Digital technologies, the near-ubiquity of broadband internet connections and the rapid development of artificial intelligence have increased the salience of theories that explain the role of knowledge and innovation in disrupting markets, creating network effects, economies of scale and platforms. As the basic infrastructure for digital technologies is built out across low- and middle-income countries, it will be important for DFIs to understand and pursue the opportunities for market development that arise. New growth theories provide a good framework to do so.

To exploit these opportunities, DFIs need to start from a market perspective, manage their investments on a portfolio basis and take more equity risk. They should promote knowledge generation and sharing, and promote standards, as a core part of their business. This will enable DFIs to be truly catalytic in promoting private sector development in low- and middle-income countries.

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