Institutions Matter: Governance and the Role of DFIs in Mobilizing Private Investment

A Panel Data Analysis of Blended Finance and Institutional Enablers in the SDG Era

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Abstract

This thesis examines how governance quality influences the ability of Development Finance Institutions (DFIs) to mobilize private investment in developing countries. In this study, mobilized private investment (MPI) refers to the portion of private investment that can be attributed to the presence of DFIs through guarantees, concessional loans, or equity participation. Using panel data from 104 developing countries between 2012 and 2023, the study investigates how three aspects of governance, namely Rule of Law, Regulatory Quality, and Government Effectiveness, influence the volume of MPI. A random effects panel regression approach is used, along with Principal Component Analysis (PCA) to construct a composite governance index. The analysis also includes an interaction term for the post-COVID period and a comparative model using foreign direct investment (FDI) as a benchmark.

The findings show that stronger governance is significantly associated with higher levels of mobilized private investment. Among the three dimensions, regulatory quality has the largest and most consistent effect. Results also indicate that governance may have become more influential in the post-COVID period. These patterns hold across robustness checks, including alternative specifications and comparisons with FDI trends.

The thesis contributes to development finance research by providing empirical evidence that institutional quality is a key enabler of blended finance. However, it also highlights a distributional challenge: DFIs appear more effective in countries already on a development trajectory, while those with weaker institutions risk being left behind. The study underscores the importance of integrating governance diagnostics, risk-sharing tools, and institutional support into future blended finance strategies.
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Abbreviations

Abbreviation	Description
AIC	Akaike Information Criterion
BIC	Bayesian Information Criterion
CPI	Consumer Price Index
DFI	Development Finance Institution
FDI	Foreign Direct Investment
FE	Fixed Effects
GMM	Generalized Method of Moments
GovEff	Government Effectiveness
LMIC	Low- and Middle-Income Country
MPI	Mobilized Private Investment
ODA	Official Development Assistance
PCA	Principal Component Analysis
PPP	Purchasing Power Parity
RE	Random Effects
RMSE	Root Mean Square Error
SDG	Sustainable Development Goal
SLU	Swedish University of Agricultural Sciences
UNCTAD	United Nations Conference on Trade and Development
WGI	Worldwide Governance Indicators

1. Introduction

Achieving the Sustainable Development Goals (SDGs) by 2030 requires financing on a scale far beyond what public budgets can provide. Even before the COVID-19 pandemic, the annual investment gap for developing countries was estimated at 2.5 trillion US dollars. Since then, the gap has widened significantly, with projections now exceeding 4 trillion dollars each year and potentially reaching 6 trillion by the end of the decade (UNCTAD, 2024). Mobilizing private capital has therefore become a central objective in global development policy.

In this thesis, mobilization refers to the portion of private investment that can be attributed to the presence of public or development finance, such as when DFIs use guarantees, concessional loans, or equity to attract private co-investors who would otherwise not participate. Following the OECD DAC (2016) framework, this includes both direct mobilizations, where private actors are contractually involved in a transaction, and indirect mobilization, where public support enables private investment through broader risk-reduction effects.

A simple example illustrates this concept. When a public development actor provides a partial risk guarantee for a solar power project, private lenders may participate because part of the potential loss is absorbed. If commercial banks contribute USD 40 million while the public guarantee covers USD 10 million, the USD 40 million is counted as mobilized private investment, financing that would not have occurred otherwise.

Development Finance Institutions (DFIs) have become important actors in this effort. These publicly backed institutions operate according to commercial principles and use tools such as concessional loans, guarantees, and equity investments to attract private capital into markets that are considered too risky for conventional finance. One of their main approaches involves blended finance, which combines public and private funds to scale investment in development projects.

However, DFIs do not operate in isolation. While they can help reduce risk at the project level, they cannot fully compensate for weak governance. Investors are still influenced by legal uncertainty, inconsistent regulation, and inefficient administration. These barriers are well known in the context of inward foreign direct investment (FDI), but it is less clear whether they also affect capital mobilized through DFIs. This knowledge gap matters, especially as blended finance becomes more prominent in development policy.

This thesis aims to fill that gap. It investigates whether governance quality affects the ability of DFIs to mobilize private investment in developing countries. The study uses panel data from 2012 to 2023 to examine how specific aspects of governance, including Rule of Law, Government Effectiveness, and Regulatory Quality, influence mobilized private investment (MPI), which in this thesis refers to the portion of private investment that can be attributed to the presence of DFIs through guarantees, concessional loans, or equity participation. It also explores whether these relationships changed after the COVID-19 pandemic and compares the findings with FDI patterns to provide additional context.

The research makes three main contributions. First, it offers empirical evidence on how institutional conditions affect the effectiveness of DFIs, which remains a relatively underexplored area. Second, it uses both individual and combined indicators of governance to provide a clearer picture of which dimensions are most influential. Third, it introduces a post-pandemic perspective, recognizing that governance may have become more important in an environment shaped by global uncertainty and heightened investment risk.

The structure of the thesis is as follows. Chapter 2 reviews the relevant literature on development finance, governance and private investment. Chapter 3 outlines the theoretical framework and research hypotheses. Chapter 4 presents the data sources and methodological approach. Chapter 5 discusses the empirical results, followed by broader interpretation in Chapter 6. Chapter 7 concludes with policy implications and directions for future research.

2. Literature Review

This chapter reviews the existing literature on development finance, governance, and private investment in developing countries. It begins by outlining the evolution of blended finance and the growing role of in mobilizing private capital. The chapter then examines empirical research on institutional quality as a determinant of investment flows, highlighting both macroeconomic and governance-related barriers. Finally, gaps in the literature are identified to motivate the study's research question and theoretical contribution.

2.1 Development Finance, DFIs, and Private Capital Mobilization

2.1.1 Blended Finance and Mobilized Private Investment

Blended finance has emerged over the past decade as a key mechanism to attract private capital into development sectors traditionally perceived as high risk or commercially unattractive defined by the OECD (2018) as "the strategic use of development finance to mobilize additional finance towards sustainable development in developing countries", blended finance seeks to combine concessional public funding with commercial investment, thereby leveraging limited public resources to unlock larger volumes of private capital.

The mobilization of private capital through blended finance is often quantified using the concept of MPI, a metric that attempts to measure the portion of private sector financing attributable to the presence of public or philanthropic capital. The OECD DAC (2016) provides one of the most widely cited frameworks, distinguishing between direct and indirect mobilization depending on whether private actors are involved in the transaction through active co-financing or through broader enabling support. These definitional frameworks have been influential in both academic and institutional analyses of capital mobilization.

Blended finance is increasingly recognised by scholars as a promising approach for achieving both financial leverage and development impact. According to Savoy, Carter, and Lemma (2016), blended finance operates at the intersection of commercial and concessional funding, using instruments such as guarantees, subordinated capital, and technical assistance. Bielenberg et al. (2016) similarly argue that these tools are essential for addressing risk perceptions and attracting private investment into sectors aligned with sustainable development goals.

Yet, the literature also highlights important concerns regarding the clarity and consistency of MPI metrics. Attridge and Engen (2019) emphasize that existing methodologies often fail to distinguish clearly between private finance that is truly catalysed by public involvement and finance that would have occurred regardless. Similarly, Carter (2022) cautions that many evaluations rely on donor-driven assumptions rather than empirical verification, which inflates mobilization figures and obscures the actual impact of blended finance in developmental terms. Another contested issue in the literature is the question of intentionality and additionality, two principles that determine whether blended finance is effectively "crowding in" private finance. While many institutions report mobilization ratios, Nancy Lee (2017) argues that without clearer attribution models and robust counterfactuals, it's difficult to assess whether public capital is genuinely mobilizing new investment or merely accompanying it. Moreover, sectoral and regional imbalances persist. Studies by OECD (2020) and Schmidt-Traub and Sachs (2015) show that blended finance flows tend to cluster in middle-income countries and low-risk sectors like financial services, bypassing the most underserved contexts where additionality would be highest.

Despite these critiques, blended finance remains a cornerstone of institutional efforts to meet SDG financing needs. The World Bank, IFC, and regional development banks regularly publish mobilization metrics and case studies that underscore the centrality of MPI in their operating models. However, the academic literature still lags in providing disaggregated, theory-driven, and context-sensitive analyses of how MPI is defined and operationalized across institutions, sectors and regions. This gap points to a need for more structured inquiry in assumptions, mechanisms, and measurement practices that underpin MPI, particularly as blended finance strategies evolve in response to post-Covid fiscal constraints and geopolitical shifts.

2.1.2 The Role of DFIs and MDBs in Mobilizing Private Investment

The role of DFIs and Multilateral Development Banks (MDBs) in mobilizing private investment has been extensively debated in the literature, particularly regarding the functions, effectiveness, and underlying assumptions of their interventions. Scholars widely acknowledge that DFIs and MDBs serve as critical intermediaries between public objectives and private market mechanisms, yet empirical findings reveal substantial variation in outcomes, especially across instruments and contexts.

Research by Attridge and Engen (2019) suggests that DFIs and MDBs predominantly leverage three categories of instruments, such as guarantees, equity

investments, and syndicated loans, to mitigate risks perceived by private actors. Guarantees, especially political risk guarantees as offered by Multilateral Investment Guarantee Agency (MIGA), have been found effective in addressing sovereign and regulatory risks, yet their mobilization impact appears to vary between sector and region (MIGA, 2023). However, Humphrey and Prizzon (2014) caution that reliance on guarantees may induce a selection bias toward already "bankable" projects limiting their ability to extend capital flows to genuinely underserved markets.

Equity participation by DFIs, notably by institutions like IFC and British International Investment, has attracted critical scrutiny regarding tension between developmental mandates and return expectations. As Musacchio, Lazzarini, and Makhoul (2014) argue, DFI equity operations often face pressures to prioritize commercially viable sectors, raising concerns about "mission drift" away from high-need, high-risk environments. Empirical data from the IFC (2020) suggests a relatively high mobilization ratio, yet independent evaluations have pointed to an overconcentration in financial services and infrastructure in middle-income countries (OECD, 2020), aligning with earlier criticisms of sectoral bias (Lee, 2017)

The literature on syndicated loans also reveals a nuanced picture. While syndicated loans allows DFIs to play an anchoring role and enable risk-sharing among private lenders (AfDB, 2022), studies by Kingombe, Massa and te Velde (2011) emphasize that the developmental additionality of such structures is frequently ambiguous. Syndicated loans tend to cluster around relatively safe, revenue-generating sectors, thus potentially reinforcing rather that correcting market failures.

A growing strand of scholarship interrogates the measurement of private mobilization itself. As Habbel et al., (2021) and Attridge and Engen (2019) note, institutional self-reporting on mobilized private capital often lacks transparency regarding attribution models and counterfactuals. Methodological heterogeneity across MDBs and DFIs complicates cross-institutional comparisons and may lead to inflation of mobilization claims (OECD, 2023). The persistence of methodological inconsistencies challenge efforts to assess the true effectiveness of DFIs' mobilization strategies and calls into question the robustness of existing evidence bases.

Real-world case studies also offer mixed evidence. Programs such as IFC's Scaling Solar in Africa have been cited as exemplars of effective private sector mobilization in high-risk markets (IFC, 2021). Yet, other initiatives, such as

blended finance vehicles in fragile states operated by the European Bank for Reconstruction and Development, have struggled to demonstrate additionality without substantial concessional support (EBRD, 2022). These contrasting cases suggests that the effectiveness of DFIs and MDBs is not inherent to the institutions themselves but dependent upon context-specific factors such as political stability, regulatory frameworks and sectoral characteristics.

Overall, while DFIs and MDBs occupy a central position in the architecture of private capital mobilization, the academic literature reflects substantial scepticism regarding the depth, breadth, and developmental quality of the investment flows they catalyse. Calls for standardized measure frameworks, stronger emphasis on additionality, and greater transparency in reporting underscore the evolving research agenda on the mobilization role of DFIs and MDBs, especially in the context of heightened financing need post-Covid and amidst rising geopolitical uncertainties.

2.2 Governance, Institutions, and Investment Dynamics

2.2.1 Rule of Law and Institutional Quality

The relationship between institutional quality and private capital mobilization has become a central focus of development finance literature. Scholars broadly concur that strong governance frameworks, characterized by transparency, legal predictability, and effective enforcement mechanisms, are essential prerequisites for attracting and sustaining private investment flows, particularly in developing countries (Acemoglu & Robinson, 2013; North, 1990). Weak institutions not only elevate perceived risks, such as expropriation, contract breaches, and regulatory unpredictability, but also worsen information asymmetries that discourage private sector participation.

Several empirical studies demonstrate that the Rule of Law, Regulatory Quality, and Government Effectiveness are positively correlated with FDI inflows and blended finance mobilization (Globerman & Shapiro, 2003; Kaufmann et al., 2011). The WGI project, developed by the World Bank, provides one of the most widely cited sources for measuring institutional quality across six dimensions: Rule of Law, Control of Corruption, Government Effectiveness, Regulatory Quality, Political Stability, and Voice and Accountability. These metrics serve as a key reference point for DFIs in assessing country risk and determining strategic engagement (World Bank, 2024).

Rule of Law, as conceptualized in this context, relates to the extent to which agents have confidence in and abide by societal rules, including contract enforcement, property rights, the police, and the courts. Empirical analyses underscore its foundational role in structuring incentives for private investment. For example, Keefer and Knack (1997) find that credible commitment mechanisms embedded within strong legal systems are significantly associated with higher levels of private investment and economic growth. Similarly, Hallward-Dreimer and Pritchett (2015) argue that even when formal laws exist, their actual enforcement, what they term the "de facto" regulatory environment, is crucial for shaping investment decisions.

The literature also points to the asymmetry between formal institutional reforms and actual institutional practice. While many countries adopt reforms under external pressure, e.g., structural adjustment programs or donor conditionality, the persistence of informal practices and selective enforcement often undermines the credibility of institutional improvements (Andrews, 2013; Rodrik, 2007). Such discrepancies are particularly problematic for private investors, who rely on predictable enforcement than merely the existence of formal rules.

Furthermore, the risk-mitigating role of strong institutions extends beyond purely economic considerations. According to North, Wallis and Weingast (2009), effective institutions create "open access orders", where competition in political and economic spheres limits rent-seeking and elite capture, factors that otherwise distort investment climates and inhibit market entry for private actors.

In some specific context of mobilizing private capital for development finance, institutional quality serves both a direct and an enabling function. Directly, it influences investor's cost of capital and project viability assessments. Indirectly it affects broader investment ecosystem by shaping infrastructure development, access to justice, and the stability of regulatory frameworks, conditions critical for long-term project sustainability. The World Bank (2017) highlights that efficient regulatory environments and strong legal institutions directly influence firms' cost of capital and the feasibility of long-term investments, while weak institutional quality raises transaction costs and risks, thereby undermining sustainable private sector engagement.

Despite the consensus on their importance of institutional quality, measuring and operationalizing these factors remains a contested domain. Critics such as Kurtz and Schrank (2007) highlight potential biases and methodological inconsistencies in composite governance indicators like the WGI, raising concerns about their use in policy conditionality and investment decision-making. Nonetheless, in the

absence of more granular and context-sensitive alternatives, such as indices continue to inform both academic research and institutional practice.

2.2.2 Empirical Evidence Linking Governance to Investment

Empirical research consistently affirms that governance quality is a critical determinant of private sector investment flows across developing countries. Early cross-country studies such as Wheeler and Mody (1992) and Asiedu (2006), demonstrate that political risk, regulatory opacity, and judicial inefficiencies significantly deter FDI inflows, often outweighing traditional market factors like labour costs or resource availability. Their finding highlights that beyond economic fundamentals, the predictability and reliability of the investment environment substantially influence capital allocation decisions.

At the firm level, survey-based research such as the World Bank's Enterprise Surveys (2022) provides granular evidence that weak institutions manifest as real operational barriers for investors. Commonly cited obstacles include delays in licensing, arbitrary enforcement of regulations, and widespread corruption, all of which raise transaction costs and deter long-term investment commitments. Similarly, Cuervo-Cazurra (2006) finds that corruption not only reduces the quantity of investment but also distorts the type of projects undertaken, favouring short-term, easily liquidated ventures over strategic, developmental investments.

Emerging work at the intersection of governance and blended finance suggests that institutional quality remains a decisive variable even when risk mitigation instruments are present. Based on blended finance project evaluations, Attridge and Engen (2019) observe that private capital mobilization remains heavily skewed toward middle-income countries with relatively robust governance frameworks, despite intentional efforts to deploy risk-sharing mechanisms in frontier markets. In the context of blended finance, where DFIs aim to crowd in private capital using risk-mitigation tools, a related analysis by Honohan and Beck (2007) emphasizes that financial sector governance, including contract enforcement in lending and property registries, is particularly crucial for mobilizing private investment at scale.

Nonetheless, important gaps persist in this empirical literature. Existing studies often disproportionately sample middle-income economies, underrepresenting the governance challenges faced by fragile and conflict-affected states. Moreover, indicator usage varies widely: while some analyses employ broad governance indices, others focus narrowly on corruption perception or regulatory quality, complicating comparative insights into how post-COVID fiscal and political volatility has reshaped investor behaviour and governance risks.

3. Theoretical Framework

This chapter develops the theoretical foundations that guide the analysis of governance and private capital mobilization. It begins by outlining the role of institutions in shaping investment incentives, emphasizing how weak contract enforcement and insecure property rights discourage long-term commitments. Building on this, the chapter introduces the hold-up problem, which explains how relationship-specific investments are vulnerable to opportunism in settings with incomplete contracts. The discussion then turns to transaction cost economics and the investment climate literature, which highlight how weak governance raises costs, heightens perceived risks, and constrains the universe of bankable projects. The role of DFIs is examined as a mediating force that can partially offset these governance constraints through guarantees, concessional finance, and technical assistance. Finally, these perspectives are synthesized into a conceptual framework that generates three testable hypotheses on the relationship between governance quality, DFIs, and the mobilization of private investment.

3.1 Institutions and Investment

Institutions, defined by North (1990) as the "rules of the game," form the foundational structures that shape economic behaviour and investment decisions. By providing stability, predictability, and credible enforcement of contracts, institutions reduce uncertainty and create the conditions under which private actors are willing to commit resources to long-term projects. In the absence of strong institutions, property rights are insecure, contracts are difficult to enforce, and investors face heightened risks of expropriation or opportunistic behaviour. These risks are particularly prominent in developing countries, where institutional weaknesses often translate into volatile regulatory environments and weak legal enforcement. Prior work has shown that institutional quality is a central determinant of economic development and private capital flows (Acemoglu & Robinson, 2013; Globerman & Shapiro, 2003).

For the purposes of this thesis, however, the focus is not on the broad distinction between inclusive and extractive institutions, but rather on the specific mechanisms through which institutional quality shapes the incentives and capacity of private actors to invest alongside DFIs. In this sense, institutions serve as the backdrop against which blended finance initiatives succeed or fail, as they directly influence the credibility of contracts, the security of property rights, and the broader investment climate.

3.2 The Hold-up Problem and Underinvestment

A central mechanism linking institutions to investment outcomes is the so-called hold-up problem. When investments are relationship specific, meaning that their value depends on long-term cooperation with a particular partner, investors face the risk that counterparties may act opportunistically once the investment is sunk. In environments with weak contract enforcement, incomplete legal frameworks, or limited recourse to impartial courts, these risks cannot be credibly mitigated. As a result, investors rationally underinvest, even in projects with high social returns, because they anticipate the possibility of expropriation, renegotiation, or policy reversal. This mechanism has been formalized in seminal work on incomplete contracts and property rights (Klein, Crawford and Alchian, 1978; Williamson, 1979, 1985; Grossman and Hart, 1986; Hart and Moore, 1990). More recent empirical research, such as Nunn (2007), demonstrates how weak enforcement of contracts systematically distorts trade and investment patterns across countries.

This problem is particularly acute in developing economies where institutional constraints amplify transaction risks. It also highlights the economic rationale for DFIs. By providing guarantees, concessional loans, or equity stakes, DFIs attempt to reduce the perceived risk of opportunism and make relationship-specific investments viable. Yet, as this thesis argues, the effectiveness of DFIs in overcoming hold-up risks remains conditional on the broader governance environment. Where contract enforcement is fundamentally unreliable, even generous de-risking instruments may fail to mobilize substantial private capital.

3.3 Transaction Costs and Governance

Beyond the hold-up problem, weak institutions also raise the broader costs of making and enforcing transactions. Transaction cost economics, as developed by Williamson (1985), emphasizes that uncertainty, monitoring, and enforcement costs shape how firms and investors organize their activities. In countries where legal systems are unreliable, regulations are inconsistently applied, or corruption is pervasive, the costs of negotiating, enforcing, and safeguarding contracts increase substantially. These transaction costs manifest in the form of higher risk premiums, greater due diligence requirements, and the need for costly safeguards, all of which discourage long-term and large-scale private investment.

DFIs play a role in mitigating these transaction costs. By providing guarantees, acting as anchor investors in syndications, or offering technical assistance, DFIs can reduce information asymmetries and reassure private investors about the credibility of a project. However, the effectiveness of these instruments is still shaped by the broader governance context. In environments where the legal and regulatory system remains fundamentally weak, DFIs may only partially succeed in lowering transaction costs, limiting their capacity to mobilize substantial volumes of private capital.

3.4 Risk perception and Investment Climate

The investment climate is ultimately determined by how investors perceive risk in a given country. Even when projects appear financially attractive, weak governance can increase perceived risks through policy uncertainty, the threat of expropriation, regulatory reversals, or widespread corruption (Busse and Hefeker, 2007; Globerman and Shapiro, 2003). These risks raise the required rate of return that private investors demand before committing capital, and in many developing countries, they push otherwise viable projects below the threshold of bankability. In contrast, strong governance reduces these risks by providing transparency, consistency, and accountability in policymaking, which improves investor confidence and lowers the cost of capital.

DFIs attempt to alter these risk perceptions by offering guarantees, concessional loans, and other de-risking instruments. While such tools can shift the risk-return calculus in favor of investment, their effectiveness depends heavily on the surrounding institutional environment. In contexts with moderate governance quality, DFIs can help expand the universe of bankable projects by lowering perceived risks just enough to crowd in private finance. However, in contexts characterized by pervasive institutional fragility, even generous support may not overcome negative risk perceptions, leaving investors unwilling to commit.

3.5 DFIs as Mediators of Governance Constraints

DFIs are explicitly designed to operate in environments where governance constraints discourage private investment. Their mandate is to mobilize capital into high-risk settings by deploying instruments that reduce or share risks. Guarantees protect investors against political or regulatory shocks, concessional loans improve the financial viability of projects by lowering borrowing costs, and equity participation signals confidence while aligning incentives with private investors. DFIs also provide technical assistance and policy dialogue, which can indirectly strengthen regulatory frameworks and investment procedures.

These functions allow DFIs to partially offset the weaknesses of institutional environments. By acting as credible intermediaries, they can reduce perceived risks and lower the barriers associated with transaction costs and hold-up problems. Nevertheless, DFIs cannot fully substitute for strong institutions. When governance deficits are severe, such as when contract enforcement is unreliable or corruption is systemic, even substantial de-risking efforts may not succeed in mobilizing private co-financing. In this sense, DFIs are best understood as mediators: their effectiveness depends not only on the design of their instruments but also on the baseline quality of the governance environment in which they operate.

3.6 Conceptual Framework and Hypotheses

The preceding sections have outlined the mechanisms through which governance quality shapes private investment mobilization. Strong institutions provide credible contract enforcement and secure property rights, reducing the risk of opportunism and mitigating the hold-up problem. They also lower transaction costs by ensuring transparent and predictable regulatory processes, and they improve the investment climate by reducing the perceived risks faced by private actors. In turn, this makes more projects bankable and increases the likelihood that private investors will co-finance projects supported by DFIs.

DFIs act as intermediaries that can partially offset governance weaknesses by offering guarantees, concessional finance, and technical assistance. However, their effectiveness is conditional on the baseline quality of the institutional environment. In contexts with moderate governance capacity, DFIs can tip the balance of risk and return in favor of investment. In contexts with very weak governance, by contrast, even substantial de-risking may fail to crowd in private capital. The COVID-19 pandemic further underscored the importance of institutions, as global uncertainty heightened investor sensitivity to governance quality. It is therefore plausible that governance has become even more influential in shaping mobilization outcomes in the post-2020 period.

Based on this conceptual framework, the following hypotheses are proposed:

- **H1:** Higher levels of governance quality, as measured by the WGI, are associated with higher levels of MPI.
- **H2:** The positive association between governance quality and MPI is stronger in the post-COVID period (2020–2023).
- **H3:** A composite governance index, constructed using the first principal component of a PCA, is positively associated with MPI.

Together, these hypotheses translate the theoretical arguments into testable propositions for the empirical analysis that follows. They summarize the expectation that governance quality is a foundational enabler of blended finance, while also recognizing the catalytic but conditional role of DFIs in mediating governance constraints.

4. Data and Methodology

This chapter outlines the data sources, variable construction, and methodological approach used in the study. It begins by describing the panel dataset and key variables related to governance, private investment, and control factors. The following sections detail the model specification, including the baseline random effects regression and extensions using interaction terms and a composite governance index. A comparative model using FDI is also introduced. The chapter concludes with a summary of the estimation strategy and its alignment with the research objectives.

4.1 Data Sources

This study complies a comprehensive panel dataset from 104 developing countries between 2012 and 2023, integrating country-level data from multiple authoritative international sources. The selected databases are widely recognized for their methodological rigor, transparency and relevance to research in development finance, institutional quality, and macroeconomic performance. Together, they enable a multidimensional analysis of how governance affects the mobilization of private investment by DFIs in developing countries.

4.1.1 OECD Mobilisation Database

The Organisation for Economic Co-operation and Development (OECD) is an intergovernmental organization with a mandate to promote policies that improve economic and social well-being globally (OECD, 2025). Its Mobilisation Database is a unique and standardized resource that tracks amounts of private finance mobilized by official development finance interventions, including guarantees, syndicated loans, and equity investments. Data are compiled in collaboration with major bilateral and multilateral DFIs and development agencies. This database provides the dependent variable for the study, MPI, reported in constant international U.S dollars. It enables cross-country comparisons and trend analysis of blended finance performance over time. Appendix A provides a detailed breakdown of country-year observations, and the total mobilized private investment across all included countries.

Figure 1 shows the geographic distribution of total MPI between 2012 and 2023 across the countries included in the sample. Countries with higher levels of private capital mobilization are shaded in darker green.

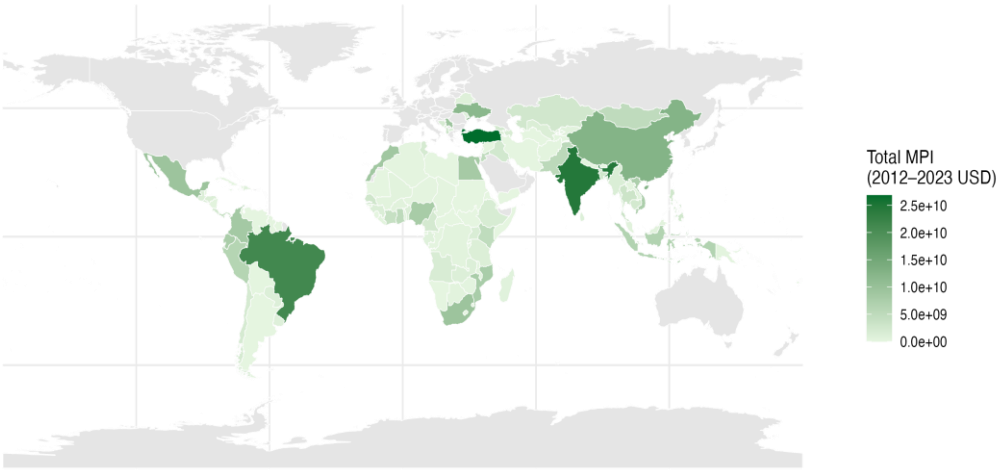

Figure 1. Total Mobilized Private Investment (2012–2023)

4.1.2 Worldwide Governance Indicators

The WGI project, developed by the World Bank, provides annual assessments of institutional quality across more than 200 countries and territories (World Bank, 2024). It aggregates data from over 30 sources, including surveys of households, firms, NGOs, and public sector organizations. This study focuses on three governance dimensions:

Rule of Law, which reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, including contract enforcement, property rights, and the courts.
Regulatory Quality, which captures perceptions of the government's ability to formulate and implement sound policies and regulations that permit and promote private sector development; and
Government Effectiveness, which measures the quality of public services, the capacity of the civil service, and the credibility of the government's commitment to policies.

The values are expressed in standard deviations from the global mean, meaning that a one-unit increase reflects a one standard deviation improvement relative to all countries in the dataset. As such, even modest movements on this scale can reflect substantial changes in institutional quality, equivalent to moving from a fragile or transitional governance setting toward a more stable and effective institutional environment.

Figure 2 displays governance quality scores in 2023 based on the WGIs. Darker shades of red indicate lower governance scores. The map highlights substantial variation across regions, particularly in Sub-Saharan Africa and South Asia.

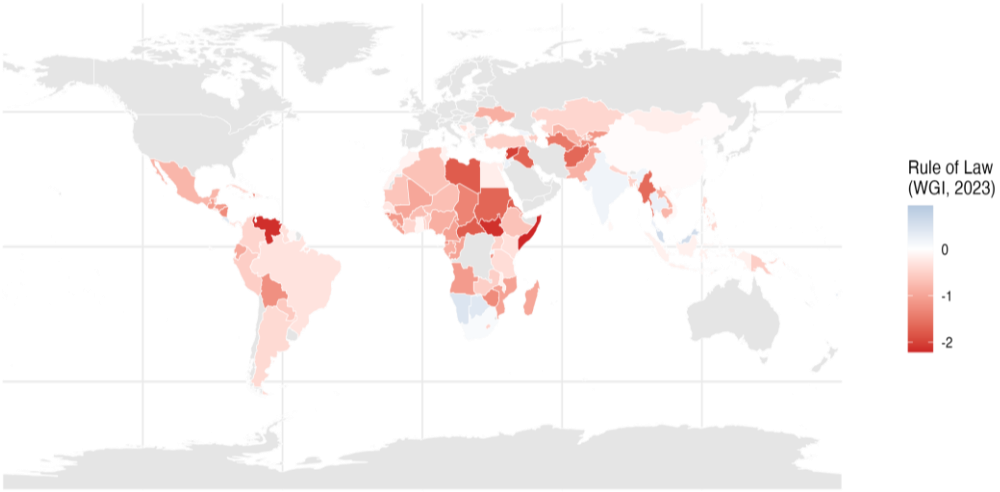

Figure 2. Governance Quality by Country (WGI, 2023)

4.1.3 World Development Indicators

The World Development Indicators (WDI) database, maintained by the World Bank, is one of the most comprehensive sources of global development data (World Bank, 2025). It includes economic, social, and environmental indicators collected from officially recognized international sources. For this research, WDI provides a range of control variables, such as GDP per capita, inflation, trade openness, and population, that account for structural and macroeconomic factors affecting investment flows. The data are harmonized annually and allow for robust modelling at the country-year level.

4.2 Variable Construction

Table 1 provides an overview of the variables used in the empirical analysis, including their definitions, transformations, and data sources. The dependent variable, Log_MPI, captures annual mobilized private investment by DFIs in constant 2015 USD, log-transformed to normalize distribution. In addition, Log_FDI is included as a comparative outcome, reflecting broader private capital inflows. Explanatory variables include governance indicators from the WGI: Government Effectiveness (GovEff), Rule of Law, and Regulatory Quality. Control variables are drawn from the WDI and include GDP (log-transformed), inflation, trade as a percentage of GDP, and population (log-transformed). These variables represent key macroeconomic and institutional factors relevant to investment dynamics in developing countries.

Table 1. Overview of Variables and Data Sources

Variable Type	Variable Name	Description / Definition	Source
Dependent Variables	Log_MPI	Mobilized private investment by DFIs in constant 2015 USD, aggregated annually by country and log-transformed	OECD Mobilisation Database
	Log_FDI	Inward foreign direct investment inflows, reported in constant 2015 USD and log-transformed to normalize distribution	World Development Indicators (WDI)
Explanatory Variables	GovEff	Perceptions of public service quality, policy formulation, and implementation effectiveness	Worldwide Governance Indicators (WGI)
	RuleOfLaw	Measures confidence in the legal system, including enforcement of contracts and property rights	WGI
	RegQuality	Assesses ability to formulate and implement sound policies and promote private sector development	WGI
Control Variables	Log_GDP_Const2015	GDP in constant 2015 USD (log-transformed); proxy for market size	WDI
	Infl	Annual inflation rate (CPI); proxy for macroeconomic stability	WDI
	Trade_GDP	Total trade (exports + imports) as % of GDP; proxy for economic openness	WDI
	Log_Population	Log of total population; controls for country size and demographic scale	WDI

4.3 Model Specification

This section outlines the empirical strategy used to investigate how governance quality influences the mobilization of private investment by DFIs in developing countries. It also assesses whether this relationship changed during the post-

COVID period. The analysis employs fixed effects panel regressions to control for unobserved country-specific heterogeneity, alongside interaction terms to examine the effect of governance under systemic stress.

A potential concern in this analysis is the endogeneity of governance indicators. Governance may influence investment mobilization, but it is also possible that investment flows contribute to governance reforms, creating reverse causality. In addition, unobserved historical or structural factors may affect both governance and investment outcomes. The empirical literature has addressed this issue using instrumental variable (IV) approaches, for example settler mortality (Acemoglu et al., 2001) or legal origins (La Porta et al., 1999). Such methods are not applied in this thesis, which instead treats governance indicators as exogenous. Consequently, the results should be interpreted as evidence of associations rather than strict causal effects.

4.3.1 Random Effects Panel Regression

The analysis employed a random effects (RE) panel regression approach to investigate how governance quality influences MPI. This method leverages both within-country and between-country variation over time, enabling broader generalization while controlling for unobserved heterogeneity across countries.

Although the analysis initially considered a fixed effects (FE) model, the Hausman test ($\chi^2 = 7.40$, $p = 0.192$) indicated no systematic difference between the FE and RE estimators. This suggests that country-level differences are not correlated with the explanatory variables, which makes it reasonable to use random effects to take advantage of both within-country and between-country variation. The random effects model was therefore selected as the primary specification, following standard panel econometric guidance (Wooldridge, 2010). The full test output is provided in Appendix B. This approach also allows time-invariant country-level characteristics, such as legal systems or geography, to enter the model as part of the error structure rather than being absorbed by fixed intercepts.

The estimation equation is specified as follows:

$$Log\_MPI_{it} = a_i + \beta_1 Governance_{it} + \beta_2 X_{it} + \lambda_t + u_i + \varepsilon_{it}$$

Where:

- Log_MPI_{it} is the natural logarithm of mobilized private investment in country i at time t, sourced from the OECD Mobilization Database.
- a_i denotes country-specific fixed effects capturing all time-invariant characteristics of each country.

- λ_t represent fixed effects, which control for global shocks or common time trends, such as changes in global capital markets or international development finance norms.
- $Governance_{it}$ is the governance indicator of interest, drawn from the WGI dataset. In separate specifications, this may include Government Effectiveness, Rule of Law, or Regulatory Quality.
- X_{it} is a vector of time-varying macroeconomic control variables including log GDP per capita, log inflation, trade as a percentage of GDP, and log population.
- u_i represents the unobserved country-specific random effect
- ε_{it} is the idiosyncratic error term.

This model allows us to estimate the effect of governance quality on private investment, while accounting for both differences across countries and changes over time.

All monetary variables are log-transformed to normalize skewed distributions and facilitate interpretation in semi-elasticity terms (percentage changes). Standard errors are clustered at the country level to account for heteroskedasticity and serial correlation over time (Hoechle, 2007).

4.3.2 Composite Governance Index (PCA)

To assess the combined influence of multiple governance dimensions, a composite index is constructed using Principal Component Analysis (PCA). This approach addresses multicollinearity among the indicators from the WGI dataset and allows for a more concise specification. The six governance dimensions included are Rule of Law, Regulatory Quality, Government Effectiveness, Control of Corruption, Political Stability, and Voice and Accountability.

The first principal component is retained, as it captures the largest proportion of shared variation across the six indicators. This component is interpreted as a summary measure of overall governance quality. The index is then used as the main explanatory variable in a separate random effects regression. This specification makes it possible to evaluate whether institutional quality, when treated as a single latent construct, is associated with higher levels of mobilized private investment.

The PCA-based specification takes the following form:

$$Log\_MPI_{it} = a_i + \beta_1 GovIndex_{it} + \beta_2 X_{it} + \lambda_t + u_i + \varepsilon_{it}$$

In this formulation:

- $GovIndex_{it}$ is the first principal component extracted using Principal Component Analysis (PCA) from six Worldwide Governance Indicators (Rule of Law, Regulatory Quality, Government Effectiveness, Control of Corruption, Political Stability, and Voice and Accountability). This component is interpreted as a composite measure of overall governance quality in country i and year t.
- X_{it} is a vector of control variables, including GDP, inflation, trade openness, and population.
- λ_t captures time fixed effects.
- u_i represents the unobserved country-specific random effect
- ε_{it} is the idiosyncratic error term.

The use of a composite index provides two key advantages. First, it reduces the risk of overstating the role of any single indicator due to correlation among variables. Second, it enables a robustness check of the main findings based on a more general representation of governance. The PCA approach follows the methodology outlined by Kunčič (2014), and the underlying diagnostics are presented in Appendix E.

4.3.3 Interaction with post-COVID Dummy

To test whether the relationship between governance and private investment changed after the onset of the COVID-19 pandemic, the model includes an interaction term between governance indicators and a post-COVID dummy variable. This dummy equal 1 for the years 2020 to 2023 and 0 for all earlier years. The COVID-19 pandemic represented a global shock that increased uncertainty and placed additional stress on public institutions in many developing countries. It also disrupted investment flows and exposed the importance of institutional resilience and coordination (ITC, 2021). Including the interaction term makes it possible to assess whether governance quality became more important for investment mobilization during this period.

The extended model takes the form:

$$Log\_MPI_{it} = a_i + \beta_1 Governance_{it} + \beta_2 PostCovid_t + \beta_3 (Governance_{it}\ x\ PostCovid_t) + \beta_4 X_{it} + \lambda_t + u_i + \varepsilon_{it}$$

In this formulation:

- $PostCovid_t$ is a dummy variable equal to 1 for the years 2020-2023 and 0 otherwise.
- The interaction term $Governance_{it}\ x\ PostCovid_t$ captures whether the relationship between governance and investment changed significantly after the onset of the pandemic.

A positive and statistically significant interaction would suggest that governance mattered more during the crisis, perhaps due to greater reliance on institutional capacity to manage uncertainty and facilitate private capital flows. This is in line with finding from recent studies emphasizing institutional resilience during global shocks (Furceri et al., 2022).

Overall, this modelling strategy allows for a robust analysis of how institutional quality and macroeconomic context jointly shape the effectiveness of blended finance, and whether governance gains salience under conditions of global stress.

4.3.4 Comparative model using inward FDI

To assess whether governance influences traditional capital flows in a similar way, a comparative model is estimated using FDI as the dependent variable. This allows for a contrast between private capital mobilized through DFIs and market-driven investment patterns.

The FDI model uses the same core explanatory variables, including governance indicators and macroeconomic controls. Like previous specifications, it is estimated using a random effects panel regression and includes time fixed effects to control for global trends. The purpose is to test whether the effect of governance on private investments differs when DFIs are not involved.

This comparative approach helps identify whether institutional quality plays a broader role in shaping investment flows beyond the context of blended finance. It also provides a benchmark for interpreting the magnitude and significance of governance effects in the MPI models.

4.4 Summary of Empirical Strategy

The empirical strategy is designed to evaluate how governance quality influences the ability of DFIs to mobilize private investment across developing countries. Three governance dimensions are tested individually, followed by a composite index based on Principal Component Analysis. To examine whether this relationship changed during the COVID-19 pandemic, an interaction model is included. Finally, a comparative regression using FDI as the dependent variable provides a benchmark for assessing the distinctiveness of DFI-mediated investment flows.

All models are estimated using random effects panel regressions with time fixed effects and clustered standard errors at the country level. This approach accounts

for unobserved heterogeneity across countries and controls for global shocks that could influence investment patterns over time.

5. Empirical Results

This chapter presents the main empirical findings from the panel data analysis. It begins with descriptive statistics and a correlation matrix to provide context for the regression models. The baseline results are then introduced, followed by robustness checks using a composite governance index, an interaction model capturing post-COVID effects, and a comparative regression with FDI. Each subsection provides a short interpretation of the results and their implications for the research question.

5.1 Descriptive Statistics

Figure 3 summarizes the annual volume of MPI across developing countries from 2012 to 2023. All values are expressed in constant 2015 USD, adjusted for inflation to ensure year-to-year comparability.

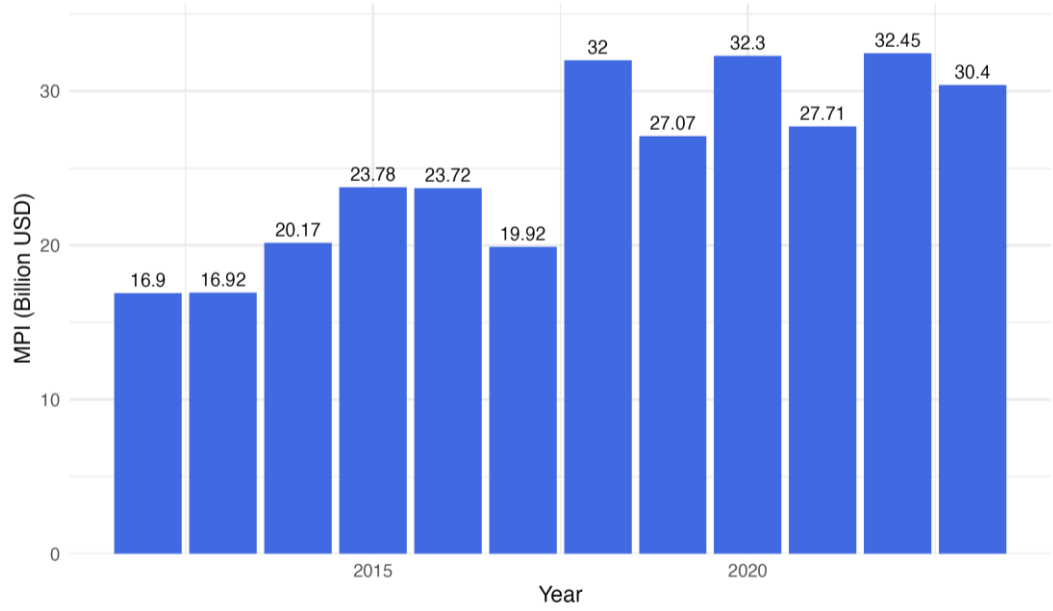

Figure 3. Trends in Mobilized Private Investment (MPI), 2012–2023

As shown in the figure, MPI increased from approximately 17 billion USD in 2012 to over 30 billion USD, peaking at 32.45 billion USD in 2022. Although there was a slight decline in 2017 and some variability during the COVID-19 period, investment levels remained well above those of the early 2010s.

This trend reflects the growing role of DFIs in catalysing private capital flows into developing economies, especially in response to global development and sustainability goals. Despite economic shocks like the pandemic, MPI levels have

remained robust, indicating a resilient commitment to blended finance strategies over the past decade.

Descriptive statistics for the regression variables are shown in Table 2. These include the dependent variable (MPI_Real), its log transformation (Log_MPI), and macroeconomic controls such as real GDP (GDP_Const2015 and Log_GDP_Const2015), inflation (Infl), trade openness (Trade_GDP), and population (Log_Population). Governance indicators from the Worldwide Governance Indicators (WGI) include Government Effectiveness (GovEff), Regulatory Quality (RegQuality), and Rule of Law (RuleOfLaw). For each variable, the table reports the number of observations (N), mean, median, standard deviation (SD), and the minimum and maximum values.

Table 2. Descriptive Statistics for Key Variables

Variable	N	Mean	Median	SD	Min	Max
GDP_Const2015 (billions USD, 2015)	1,318	254.0	23.4	1290.0	0.044	17,200.0
GovEff	1,301	-0.51	-0.53	0.63	-2.44	1.16
Infl	1,247	8.08	4.26	24.51	-6.69	557.20
Log_GDP_Const2015	1,318	24.09	23.88	1.93	17.60	30.47
Log_MPI	1,101	17.50	18.00	2.66	7.13	22.61
Log_Population	1,337	16.20	16.29	1.87	9.25	21.09
MPI_Real	1,101	2.76e08	6.56e07	5.88e08	1250.00	6.58e09
RegQuality	1,301	-0.47	-0.47	0.63	-2.36	1.48
RuleOfLaw	1,301	-0.55	-0.54	0.61	-2.38	1.35
Trade_GDP	1,183	73.69	67.96	35.55	2.47	342.70

The dataset reveals several notable patterns that provide context for the regression analysis. Mobilized Private Investment in real terms (MPI_Real) exhibits a highly skewed distribution, with a mean of approximately 276 million USD and a maximum value exceeding 6.5 billion USD. To address this skewness and improve model interpretability, the variable was log-transformed. The resulting Log_MPI variable ranges from 7.13 to 22.61, with a mean of 17.50 and a standard deviation of 2.66, reflecting substantial variation across countries and years.

Gross Domestic Product (GDP), measured in constant 2015 USD, captures the wide economic diversity of the sample. Observed values range from as low as 44 million in very small economies to over 17 trillion in larger, emerging markets. This variation underscores the importance of controlling for market size in the regression models.

Governance indicators, including Government Effectiveness, Regulatory Quality, and Rule of Law, are centred slightly below zero, as expected for many developing countries. These indicators are standardized with a global mean of zero, and their dispersion supports their inclusion as explanatory variables to account for institutional quality differences.

Inflation, included as a proxy for macroeconomic stability, also displays a skewed distribution. While the mean annual inflation rate is 8.08 percent, some countries experienced extreme values, with inflation reaching as high as 557 percent in certain years. These outliers reflect episodes of macroeconomic instability that could influence investment behaviour and DFI risk assessments.

Figure 4 presents a scatter plot of Log_MPI (log-transformed mobilized private investment in absolute USD) against Government Effectiveness from the WGI dataset. Each point corresponds to a country-year observation.

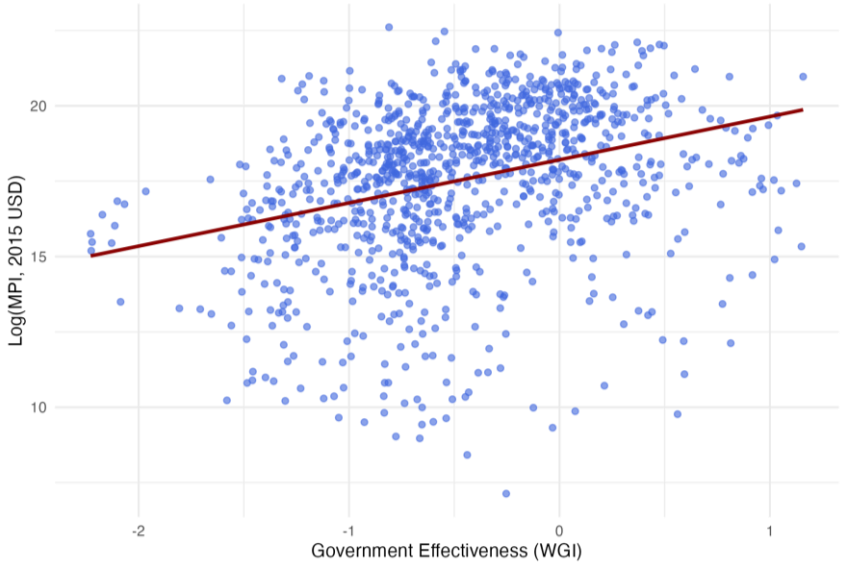

Figure 4. Relationship between Government Effectiveness and MPI

The fitted regression line suggests a modestly positive relationship, indicating that higher government effectiveness is generally associated with greater volumes of private capital mobilized by DFIs.

While the correlation is not especially strong, the direction aligns with expectations from governance and investment theory and is broadly consistent with existing empirical findings.
The considerable spread in the data suggests that other factors, such as economic size, trade openness, or inflation, also play an important role in explaining variation in mobilized investment.

5.2 Correlation Matrix

Table 3 present the pairwise Pearson correlation coefficients for the key variables included in the regression models. The strongest correlation with the dependent variable, Log_MPI, is observed with Log_GDP_Constant2015 (r = 0.56), suggesting that market size is a major determinant of private investment mobilized via DFIs. This is further reinforced by the positive correlation with Log (Population) (r = 0.44).

Table 3. Correlation Matrix of Key Variables

Variable	Log_MPI	Log_GDP_ Const 2015	Infl	Trade _GDP	RuleOfLaw	GovEff	RegQuality	Log_Population
Log_MPI	1.00	0.56	-0.11	-0.06	0.27	0.34	0.33	0.44
Log_GDP_Const2015	0.56	1.00	0.01	-0.29	0.18	0.38	0.18	0.84
Infl	-0.11	0.01	1.00	-0.05	-0.12	-0.14	-0.16	0.04
Trade_GDP	-0.06	-0.29	-0.05	1.00	0.10	0.16	0.18	-0.45
RuleOfLaw	0.27	0.18	-0.12	0.10	1.00	0.83	0.80	-0.09
GovEff	0.34	0.38	-0.14	0.16	0.83	1.00	0.81	0.04
RegQuality	0.33	0.18	-0.16	0.18	0.80	0.81	1.00	-0.16
Log_Population	0.44	0.84	0.04	-0.45	-0.09	0.04	-0.16	1.00

Among the governance indicators, Government Effectiveness (r = 0.34), Regulatory Quality = 0.33), and Rule of Law (r = 0.27) all show moderate positive associations with MPI, aligning with theoretical expectations that institutional quality improves investment climate.

Notably, the governance indicators are highly intercorrelated. For example, Rule of Law and Government Effectiveness share a correlation of 0.83. This multicollinearity is expected given that all are derived from the same source, and it motivates the use of PCA in robustness checks.

Inflation, often a proxy for macroeconomic instability, shows a weak negative correlation with MPI (r = -0.11) while Trade as % of GDP is also weakly negatively associated (r = -0.06) suggesting these factors play a smaller or more

context-dependent role. A full visual correlation matrix of the variables is presented in Appendix C.

5.3 Baseline Regression Results

To determine the appropriate panel data specification, a Hausman test was conducted to compare the fixed effects and random effects estimators. The test produced a chi-squared statistic of 7.40 with 5 degrees of freedom and a corresponding p-value of 0.192. Since the p-value exceeds the conventional threshold of 0.05, the null hypothesis of no systematic difference between the estimators could not be rejected. Therefore, the random effects model was selected as the primary specification, allowing the analysis to leverage both within-country and between-country variation in governance and macroeconomic variables.

Baseline regression results using individual governance indicators are presented in Table 4. The models show consistent and statistically significant associations across specifications. The R^2 values range from 0.285 to 0.339, indicating that approximately one-third of the variation in log-transformed MPI across country-years is explained by the included explanatory variables.

Table 4. Baseline Regression Results: Governance Indicators and Mobilized Private Investment (Log_MPI)

	Rule of Law	Gov. Effectiveness	Reg. Quality
(Intercept)	-1.159	-1.301	-0.045
	(1.474)	(1.596)	(1.371)
RuleOfLaw	0.860***		
	(0.170)		
Log_GDP_Const2015	0.675***	0.762***	0.498***
	(0.113)	(0.121)	(0.108)
Infl	-0.010***	-0.010***	-0.010***
	(0.002)	(0.002)	(0.002)
Trade_GDP	0.004	0.003	0.003
	(0.002)	(0.002)	(0.002)
Log_Population	0.145	0.015	0.340**
	(0.132)	(0.135)	(0.126)
GovEff		0.424**	
		(0.157)	
RegQuality			1.156***
			(0.153)
Num.Obs.	970	970	970
R2	0.301	0.285	0.339
R2 Adj.	0.298	0.281	0.336
AIC	4243.7	4266.1	4187.0
BIC			
RMSE	2.14	2.17	2.08

p < 0.1, * p < 0.05, ** p < 0.01, *** p < 0.001

Dependent variable: Log_MPI, defined as the natural logarithm of mobilized private investment in constant 2015 USD. All monetary variables are log-transformed. Standard errors are clustered at the country level. Significance levels: + p < 0.1, * p < 0.05, ** p < 0.01, *** p < 0.001.

Each of the governance indicators, Rule of Law, Government Effectiveness, and Regulatory Quality, is positively associated with MPI. The coefficient for Rule of Law is 0.860 and statistically significant at the 0.1 percent level. Interpreted within the range of the WGI, a one-unit improvement corresponds to an estimated 86 percent increase in mobilized private capital, holding other factors constant. This highlights the importance of legal reliability, contract enforcement, and protection of property rights in fostering investor confidence. Government Effectiveness also shows a positive and statistically significant relationship, with a coefficient of 0.424 ($p < 0.01$). This suggests that stronger administrative capacity and higher-quality public services are favourable to attracting private co-

financing. Regulatory Quality demonstrates the largest effect, with a coefficient of 1.156 ($p < 0.001$), implying that improvements in regulatory clarity and business conditions are associated with more than a doubling of mobilized private investment.

Regarding control variables, the logarithm of GDP is positive and highly significant in all models, suggesting that larger economies tend to mobilize more private capital through DFIs. Inflation is negatively and significantly associated with MPI, consistent with the view that macroeconomic instability deters private investment. In contrast, trade openness and population are not statistically significant in these specifications, suggesting limited direct influence on investment mobilization in this context. Appendix D reports regression results using all six WGI governance indicators for comparison.

5.4 Robustness Checks

To assess the robustness of the main findings, three alternative model specifications were estimated: (1) a principal component index of governance, (2) a post-COVID interaction model, and (3) a specification using inward FDI as the dependent variable. The results are summarized in Table 5.

Table 5. Extended Regression Models: Composite Governance, Post-COVID Interaction, and FDI Robustness Check

	PCA Governance Index (MPI)	Post-COVID Interaction (MPI)	Gov. Effectiveness (FDI)
(Intercept)	-3.586*	-1.107	-2.524
	(1.447)	(1.575)	(1.618)
Gov_PCA1	0.028+		
	(0.015)		
Log_GDP_Const2015	0.935***	0.726***	0.862***
	(0.103)	(0.119)	(0.135)
Infl	-0.011***	-0.010***	-0.001
	(0.002)	(0.002)	(0.001)
Trade_GDP	0.002	0.003	0.010***
	(0.002)	(0.002)	(0.002)
Log_Population	-0.113	0.050	0.088
	(0.121)	(0.133)	(0.140)
GovEff		0.356*	0.276+
		(0.162)	(0.162)
Post_Covid		0.173	
		(0.130)	
GovEff × Post_Covid		0.214+	
		(0.126)	
Num.Obs.	975	970	993
R2	0.294	0.287	0.698
R2 Adj.	0.290	0.281	0.696
AIC	4284.0	4267.1	3060.9
BIC	4318.2	4311.0	3095.2
RMSE	2.16	2.16	1.12

• $p < 0.1$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Dependent variables**:** Log_MPI (columns 1–2) and Log_FDI (column 3), both expressed as natural logarithms of constant 2015 USD. All monetary variables are log-transformed. Standard errors are clustered at the country level. Significance levels: + $p < 0.1$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$.

In the first model, the six WGI governance indicators were combined using PCA, with the first principal component (Gov_PCA1) serving as a composite governance index. Appendix E presents PCA diagnostics, including eigenvalues and loadings for the composite governance index. The coefficient for Gov_PCA1 is positive and marginally significant ($\beta = 0.028$, $p < 0.1$), suggesting that overall governance quality remains positively associated with MPI, even when dimensionality is reduced. Although the magnitude is smaller than in single-

indicator models, this result reinforces the broader hypothesis that institutional quality across multiple dimensions contributes to private capital mobilization.

The second model introduces an interaction between Government Effectiveness and a post-COVID dummy variable, equal to 1 from 2020 onward.
The interaction term is marginally significant ($\beta = 0.214$, $p < 0.1$), indicating that the influence of government effectiveness on MPI may have become stronger in the post-pandemic period. This could reflect the increased importance of administrative capacity in facilitating investment recovery and public-private collaboration during periods of uncertainty. While the main effect of Post_Covid ($\beta = 0.173$) is positive, it is not statistically significant, suggesting no universal increase in MPI across all countries. Instead, it is the combination of governance and the COVID period that appears to matter.

In the third specification, log-transformed FDI is used as the dependent variable to test whether Government Effectiveness remains a significant predictor for more market-driven capital flows. The coefficient for GovEff is again positive and marginally significant ($\beta = 0.276$, $p < 0.1$), and the model shows a substantially higher R^2 of 0.698, compared to the MPI models. This implies that FDI is more systematically driven by macroeconomic and institutional fundamentals, while MPI given its concessional and catalytic nature is more sensitive to DFI strategy and project-specific factors.

Across all three robustness checks, the direction and general significance of governance variables remain consistent. These findings support the conclusion that institutional quality is a robust enabler of private investment, even when accounting for alternative measurement strategies and temporal shocks. Moreover, the comparison between MPI and FDI outcomes underscores the differentiated role governance plays in mobilizing concessional versus commercial capital.

6. Discussion

This chapter interprets the empirical findings in relation to the theoretical framework and research question. It begins by summarizing the key results and examining the role of governance across different model specifications. The discussion then situates these findings within the broader academic literature on investment and institutional quality. Finally, the chapter outlines practical implications for DFIs and policymakers and reflects on the study's limitations and opportunities for future research.

6.1 Interpretation of Key Findings

The results of this study provide strong and consistent empirical evidence that governance quality significantly influences the mobilization of private investment by DFIs. Among the three disaggregated governance indicators assessed, Regulatory Quality remains the most economically meaningful predictor, with a coefficient of 1.156 ($p < 0.001$). This implies that a one-unit improvement on the WGI scale, roughly equivalent to a one standard deviation increase, is associated with a 115% increase in mobilized private investment, all else equal. This underscores the role of clear, consistent, and investment-friendly regulatory environments in enabling blended finance and private capital engagement.

Rule of Law also displays a strong and significant association with MPI ($\beta = 0.860$, $p < 0.001$), while Government Effectiveness remains positively related ($\beta = 0.424$, $p < 0.01$), albeit with a smaller effect size. Together, these results support the view that institutional environments characterized by reliable legal systems and competent bureaucracies help reduce investor risk and uncertainty, thereby facilitating capital mobilization through DFIs.

Among the macroeconomic controls, GDP (in constant 2015 USD) is consistently and significantly associated with higher MPI across all models, affirming that larger market size supports greater investment attraction. Inflation has a statistically significant negative effect ($p < 0.001$), confirming that macroeconomic instability undermines investor confidence. Other controls, such as trade openness and population, do not exhibit consistent or robust effects in this context.

In robustness checks, the PCA-based governance model confirms that a composite index of institutional quality is positively related to MPI ($\beta = 0.028$, $p < 0.1$), though the effect is smaller than for individual indicators. The post-COVID interaction model suggests that governance may have become even more salient

in the aftermath of the pandemic: while the main Post_Covid dummy is not significant, the interaction term (GovEff × Post_Covid) is positive and marginally significant ($\beta = 0.214$, $p < 0.1$), indicating that administrative capacity may have played a larger role in investment facilitation during times of crisis and recovery.

Finally, the model using log-transformed FDI as the dependent variable confirms that Government Effectiveness is again positively associated ($\beta = 0.276$, $p < 0.1$), and the model fit is substantially stronger ($R^2 = 0.698$). This reinforces the view that traditional capital flows are more tightly linked to institutional quality, whereas DFIs may mitigate governance risks to mobilize capital in more challenging environments. In this sense, MPI exhibits a form of risk resilience, reflecting the catalytic and concessional nature of DFI operations.

6.2 Alignment with Previous Literature

The findings of this thesis align closely with existing literature on the relationship between institutional quality and private capital flows. A long-standing body of empirical work has shown that governance quality, legal enforcement, and regulatory predictability are key determinants of FDI. Studies such as Globerman and Shapiro (2002), Busse and Hefeker (2007), and Asiedu (2006) consistently find that better institutional environments reduce transaction costs, enhance investor confidence, and increase the likelihood of foreign capital inflows.

The results here confirm that these governance dimensions also matter in the context of MPI, particularly when facilitated by DFIs. This is consistent with more recent research suggesting that DFIs are more successful in crowding in private capital when operating in environments with relatively stable governance frameworks (Carter, 2022). While DFIs may use de-risking instruments to function in fragile contexts, governance still defines the boundaries of viable mobilization. These findings also align with earlier literature noting that mobilized private investment tends to concentrate in countries with relatively higher GDP, reflecting not only market size but also a preference for investment environments perceived as more commercially viable (OECD, 2020; Schmidt-Traub and Sachs, 2015).

This thesis contributes to the literature by disaggregating governance into multiple dimensions and comparing their effects on both MPI and traditional FDI. It finds that Regulatory Quality exerts the strongest and most consistent influence. This result reinforces studies emphasizing the role of business environment reforms in enabling private sector development (Campos & Nugent, 1999).

Moreover, the inclusion of a post-COVID interaction model offers new insight into how the governance-investment relationship evolves in times of crisis. While the interaction effect is only marginally significant, its positive direction suggests that governance may have become even more significant in shaping MPI outcomes in the wake of the pandemic. This finding aligns with recent discussions around DFIs' evolving roles in resilience financing and recovery support (OECD, 2020).

These results are further supported by the comparative analysis between MPI and FDI. The latter is more tightly associated with governance quality, as indicated by a substantially higher model fit. This mirrors prior findings that FDI tends to flow to lower-risk, better-governed institutional environments (Busse & Groizard, 2008). In contrast, the lower explanatory power of governance in the MPI models likely reflects the intermediating role of DFIs, which can mobilize capital in more challenging contexts through blended finance. Nonetheless, governance remains a foundational enabler of private capital mobilization, even when risk-mitigation mechanisms are in place.

6.3 Policy Implications for DFIs

The findings of this study carry important implications for DFIs and the broader blended finance community, particularly considering the estimated $2.5 to $4 trillion annual investment gap required to meet the SDGs in developing countries (UNCTAD, 2024). Mobilizing private capital at scale is widely viewed as essential to closing this gap, especially in sectors like infrastructure, energy, and health.

This thesis shows that governance quality, especially Regulatory Quality, is a key enabler of successful capital mobilization through DFIs. While DFIs possess risk-mitigation instruments such as guarantees and concessional finance, the ability to attract private investment remains strongly shaped by the institutional context. This suggests that DFIs should treat governance as a strategic variable that informs where and how to intervene.

Several operational implications follow. First, the results highlight the importance of supporting regulatory reform. Improving investment frameworks, streamlining procedures, and enhancing transparency remain central priorities in settings with institutional constraints. Second, risk-sharing tools should be calibrated to governance conditions. In weaker but improving environments, DFIs may need to offer more concessionality or political risk coverage. In stronger contexts, lighter support may suffice. Third, governance diagnostics should play a larger role in

country strategy and project design. Finally, the post-COVID findings underscore the value of institutional resilience in sustaining private investment during crises.

At the same time, the results raise a broader concern. Countries with weaker institutions and lower GDP receive less mobilized investment, even though they may need it most. This suggests that DFIs, while effective in supportive environments, risk reinforcing global disparities by favouring countries already on the rise. To address this, DFIs may need to expand risk-sharing tools, scale up concessionality, and invest in institutional capacity alongside capital deployment.

Ultimately, closing the SDG financing gap will require not only more capital, but more catalytic capital deployed where risks are highest. DFIs must act not just as financiers, but as institutional partners that help create the conditions for sustainable private investment.

6.4 Limitations and Future Research

While this study provides new insights into the relationship between governance and MPI, several limitations should be acknowledged.

First, the availability and granularity of MPI data remain limited. Although the dataset was carefully constructed, it spans just over a decade and lacks consistent sectoral disaggregation. This constrains the ability to explore variation across investment types or DFI-specific mandates. Moreover, the use of panel regression with macro-level indicators cannot account for project-level characteristics, often decisive in blended finance, such as risk-sharing terms, sponsor experience, or developmental intent.

A further limitation is that mobilized private investment cannot be interpreted as a measure of purely private capital. Because MPI arises only alongside public or concessional finance, governance may influence total investment flows (public + private) rather than private incentives in isolation. As a result, the analysis cannot disentangle the specific effect of governance on strictly private investment using MPI alone. This limitation motivates the inclusion of FDI as a comparative outcome, providing a reference point for how governance relates to broader private capital inflows beyond the mobilization framework.

Second, the choice of a random effects model, supported by Hausman test results, relies on the assumption of no correlation between regressors and unobserved individual effects. While econometrically justified, this may restrict the capacity to isolate within-country variation in governance over time. Relatedly, the explained variation in MPI remains moderate ($R^2 = 0.28–0.34$), indicating that

project-specific, institutional, or geopolitical factors likely account for a significant portion of mobilization outcomes beyond what macro-governance indicators can capture.

Third, endogeneity remains a central limitation of the analysis. While the models assume governance affects mobilized private investment, it is also plausible that mobilization itself contributes to governance reforms over time, creating the possibility of reverse causality. In addition, omitted variables such as colonial history, geography, or cultural legacies may simultaneously shape both governance and investment outcomes. The empirical literature has primarily addressed this challenge through IV approaches. Two prominent examples are the use of historical settler mortality as an instrument for institutional quality (Acemoglu, Johnson, & Robinson, 2001) and the reliance on colonial legal traditions, or "legal origins," to proxy for institutional development (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1999). While influential, these instruments are largely time-invariant and raise concerns about the exclusion restriction, since they may also affect capital flows through channels other than governance. For these reasons, IV strategies are not applied here. As a result, the findings should be interpreted as evidence of associations rather than definitive causal effects.

Fourth, the model treats DFIs as a homogeneous group, despite significant differences in institutional mandates, sectoral focus, and mobilization strategies. This aggregation may obscure important variation in how different DFIs respond to governance conditions. Future research could disaggregate by DFI type or financing instrument, e.g., guarantees vs. debt vs. equity, to better understand institutional behaviour.

Fifth, while this thesis incorporates a post-COVID interaction term, the long-term consequences of the pandemic for both investment behaviour and governance trajectories remain uncertain. The interaction effect is marginally significant, suggesting some governance sensitivity post-2020, but further data and longer timeframes are needed to assess whether this shift is structural or temporary.

Despite these limitations, the findings provide a credible basis for advancing empirical research on the enabling conditions for blended finance. Future work may benefit from mixed-method approaches that combine panel data with qualitative case studies of DFI decision-making in specific governance contexts, particularly in fragile or transitional environments where governance dynamics and investment risks are most pronounced.

7. Conclusions

This chapter concludes the thesis by summarizing the main findings and reflecting on their implications for research and practice. It begins by restating the study's core objective and how the results address the research question. The conclusion also highlights the contributions made to the literature on development finance and institutional quality. Finally, suggestions are offered for future research that could extend or deepen the analysis presented in this study.

7.1 Summary of Research

This thesis set out to examine the relationship between institutional quality and the mobilization of private investment by DFIs. MPI has gained prominence as a critical financing stream to close the SDG investment gap, particularly in low- and middle-income countries. While DFIs are often positioned as catalysts for private capital in high-risk settings, the extent to which institutional conditions influence their effectiveness has remained underexplored.

To address this gap, the study combined macroeconomic, governance, and investment data across a panel of countries and years. Using panel regression methods, it analysed how three governance dimensions, drawn from the WGI, affect MPI levels, and how these effects compare to traditional FDI. Additional robustness checks incorporated a post-COVID interaction and a PCA-based composite governance index.

7.2 Main Findings

The analysis reveals a clear and consistent association between Regulatory Quality and the scale of private investment mobilized by DFIs, followed by Rule of Law and Government Effectiveness. These findings indicate that regulatory quality, policy consistency, and institutional reliability matter significantly, even in blended finance contexts.

GDP and inflation were also significant: market size enables greater mobilization, while macroeconomic instability deters it. Robustness checks confirmed the stability of results, including evidence that governance effects may have become more pronounced in the post-COVID period.

Comparative analysis with FDI shows that traditional private flows are more tightly constrained by governance and macroeconomic fundamentals. In contrast, the relatively lower R^2 values in the MPI models suggests that DFIs may partially

offset institutional risks, indicating degree of risk resilience in blended finance. Nonetheless, governance remains a foundational enabler across both forms of investment.

7.3 Final Reflections

This thesis contributes to the growing literature on blended finance by demonstrating empirically that DFIs do not operate in isolation. Institutional quality continues to shape their capacity to mobilize private capital. The findings reinforce the importance of aligning DFI investment strategies with governance trends and of treating the enabling environment as a core consideration in project appraisal, risk pricing, and the deployment of concessional resources.

At the same time, the study underscores the complexity of blended finance. Mobilization outcomes are likely influenced by factors beyond national-level governance, including sectoral conditions, DFI mandates, financing structures, and local implementation capacity. Future research, ideally integrating econometric methods with qualitative case studies, could help unpack these dynamics and provide more context-specific insights.

As blended finance continues to gain traction in the global development finance agenda, understanding its institutional foundations becomes increasingly important. This thesis offers one empirical step toward that goal.

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Popular Science Summary

Financing the Sustainable Development Goals (SDGs) is one of the greatest global challenges of our time. Public budgets alone are far from sufficient, which means that private investors need to play a much larger role in financing infrastructure, energy, and social development in poorer countries. However, private investors are often reluctant to enter these markets because they perceive them as too risky. Weak legal systems, inconsistent regulations, and inefficient governments increase the fear that contracts will not be respected or that projects may be expropriated.

To address this problem, many governments have created Development Finance Institutions (DFIs). These publicly backed institutions aim to mobilize private capital by offering guarantees, concessional loans, or co-investments. In practice, DFIs try to make projects in riskier countries more attractive to private investors. Yet, a key question remains: can DFIs really overcome weak governance, or do institutions still determine whether private investment is mobilized?

This thesis investigates how governance quality influences the ability of DFIs to attract private investment. Using data from 104 developing countries between 2012 and 2023, it examines three aspects of governance: the rule of law, the effectiveness of government, and the quality of regulation. The analysis finds that countries with stronger institutions consistently attract more private investment through DFIs. Among the three governance dimensions, regulatory quality has the strongest effect. Moreover, governance appears to have become even more important since the COVID-19 pandemic, when uncertainty about investment risks increased globally.

The results highlight both opportunities and challenges. On the one hand, DFIs are important catalysts that can help lower risks and mobilize billions of dollars for development. On the other hand, their success still depends on the institutional context. Countries with very weak governance may be left behind, since even DFIs struggle to attract private investors under such conditions. This suggests that improving governance is essential not only for development in general but also for making blended finance work effectively in closing the SDG financing gap.

Appendix A. Country-Year Coverage and Total MPI

Table 6. Country-Year Coverage and Total Mobilized Private Investment (2015 USD)

Country	Years Observed	Total Real_MPI in dollars
Afghanistan	8	2.35e+08
Albania	11	3.44e+09
Algeria	10	1.52e+08
Angola	12	1.64e+09
Armenia	12	1.17e+09
Azerbaijan	12	1.72e+09
Bangladesh	12	2.72e+09
Belarus	9	9.36e+08
Benin	12	1.26e+09
Bhutan	5	7.53e+06
Bolivia	12	9.25e+07
Bosnia and Herzegovina	12	2.01e+09
Botswana	9	3.70e+08
Brazil	12	2.12e+10
Burkina Faso	12	5.39e+08
Burundi	12	4.50e+07
Cambodia	12	2.28e+09
Cameroon	12	2.22e+09
Chad	10	1.81e+08
Chile	5	2.07e+09

China (People's Republic of)	12	1.27e+10
Colombia	12	8.42e+09
Congo	8	1.11e+08
Costa Rica	12	2.23e+09
Côte d'Ivoire	12	3.96e+09
Democratic Republic of the Congo	5	4.10e+08
Djibouti	7	1.76e+08
Dominican Republic	12	8.70e+08
Ecuador	12	7.71e+09
Egypt	12	8.28e+09
El Salvador	12	1.71e+09
Eswatini	6	4.82e+07
Ethiopia	12	1.77e+09
Fiji	9	1.81e+06
Gabon	12	7.46e+08
Gambia	6	9.31e+06
Georgia	12	2.32e+09
Ghana	12	5.17e+09
Guatemala	11	1.26e+09
Guinea	12	1.26e+09
Guinea-Bissau	8	6.07e+06
Guyana	7	1.53e+08
Haiti	12	1.56e+08

Honduras	12	1.33e+09
India	12	2.45e+10
Indonesia	12	6.57e+09
Iran	4	9.52e+06
Iraq	12	2.53e+09
Jamaica	10	6.37e+08
Jordan	12	4.92e+09
Kazakhstan	12	2.60e+09
Kenya	12	4.87e+09
Kyrgyzstan	12	5.23e+08
Lao People's Democratic Republic	12	4.13e+08
Lebanon	11	1.23e+09
Liberia	11	2.22e+08
Madagascar	12	6.16e+08
Malawi	12	3.90e+08
Malaysia	9	5.66e+08
Mali	12	3.53e+08
Mauritius	12	5.84e+08
Mexico	12	9.40e+09
Moldova	12	9.76e+08
Mongolia	12	4.90e+09
Montenegro	12	1.03e+09
Morocco	12	8.82e+09
Mozambique	12	7.77e+09
Myanmar	8	1.42e+09

Nepal	12	4.28e+08
Nicaragua	12	4.09e+08
Niger	12	1.05e+08
Nigeria	12	7.92e+09
North Macedonia	12	1.16e+09
Pakistan	12	5.28e+09
Palestinian Authority or West Bank and Gaza Strip	12	1.37e+09
Panama	12	4.04e+09
Papua New Guinea	11	2.39e+08
Paraguay	12	1.12e+09
Peru	12	6.23e+09
Philippines	12	2.70e+09
Rwanda	12	3.51e+08
Sao Tome and Principe	10	7.79e+06
Senegal	12	2.89e+09
Serbia	12	9.36e+09
Solomon Islands	9	6.95e+07
South Africa	12	9.43e+09
Sri Lanka	12	1.03e+09
Tajikistan	5	8.84e+07
Tanzania	12	1.18e+09
Thailand	12	3.25e+09
Timor-Leste	12	1.44e+07

Togo	11	5.05e+08
Tunisia	12	2.11e+09
Türkiye	12	2.68e+10
Uganda	12	1.53e+09
Ukraine	12	1.18e+10
Uruguay	6	8.62e+08
Uzbekistan	11	1.32e+09
Viet Nam	12	7.46e+09
Zambia	12	1.10e+09
Zimbabwe	11	2.04e+08

Appendix B. Hausman Test: Fixed vs Random Effects

Table 7. Hausman Test: Fixed vs Random Effects

Statistic	Chi_Squared	df	p_value	Decision
Hausman Test (FE vs RE)	7.4	5	0.1924	Random Effects preferred

Appendix C. Correlation Matrix

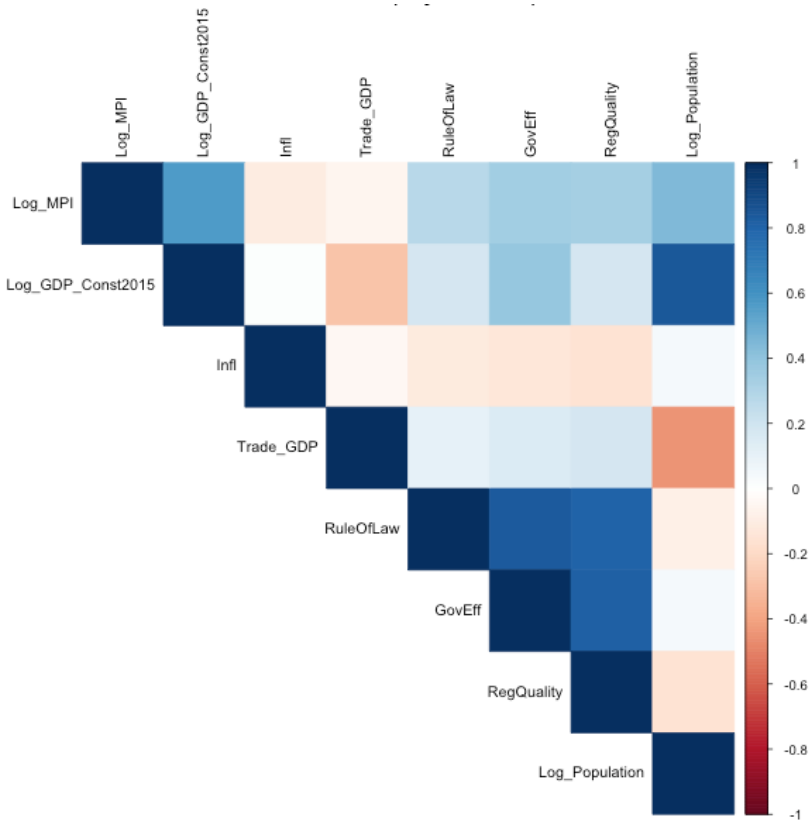

Figure 5. Correlation Matrix (Key Variables)

Appendix D. Random Effects Models for All WGI Governance Dimensions

Table 8. Random Effects Models for All WGI Governance Dimensions

	Corruption	Gov. Effectiveness	Political Stability	Rule of Law	Reg. Quality	Voice & Accountability
(Intercept)	-2.936*	-1.301	-3.165*	-1.159	-0.045	-2.761*
	(1.470)	(1.596)	(1.473)	(1.474)	(1.371)	(1.380)
Corruption	0.135					
	(0.153)					
Log_GDP_Const2015	0.898***	0.762***	0.927***	0.675***	0.498***	0.759***
	(0.111)	(0.121)	(0.109)	(0.113)	(0.108)	(0.103)
Infl	-0.011***	-0.010***	-0.011***	-0.010***	-0.010***	-0.011***
	(0.002)	(0.002)	(0.002)	(0.002)	(0.002)	(0.002)
Trade_GDP	0.003	0.003	0.003	0.004	0.003	0.005*
	(0.002)	(0.002)	(0.002)	(0.002)	(0.002)	(0.002)
Log_Population	-0.096	0.015	-0.126	0.145	0.340**	0.102
	(0.134)	(0.135)	(0.136)	(0.132)	(0.126)	(0.125)
GovEff		0.424**				
		(0.157)				
Stability			0.037			
			(0.115)			
RuleOfLaw				0.860***		
				(0.170)		
RegQuality					1.156***	
					(0.153)	
Voice						0.592***
						(0.126)
Num.Obs.	970	970	970	970	970	970
R2	0.277	0.285	0.274	0.301	0.339	0.309
R2 Adj.	0.273	0.281	0.270	0.298	0.336	0.306
RMSE	2.18	2.17	2.18	2.14	2.08	2.13

- $p < 0.1$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Appendix E. PCA Governance Index Diagnostics

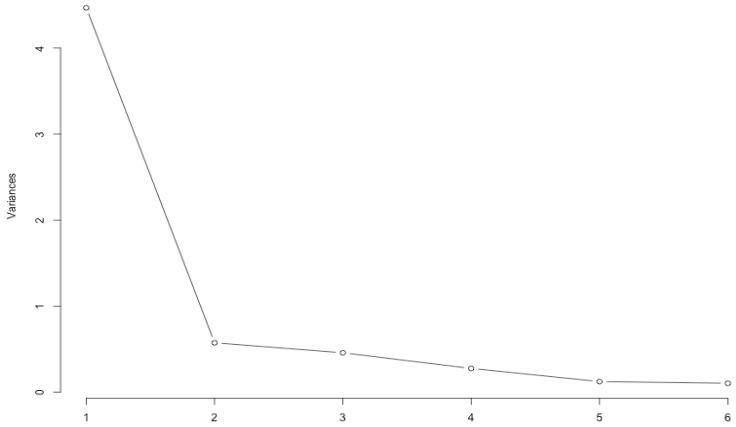

Figure 6. Scree Plot of Principal Components

Table 9. Loadings for First Principal Component

Indicator	PC1 (Gov_PCA1)
Corruption	0.4273000
GovEff	0.4232875
Stability	0.3519793
RuleOfLaw	0.4496620
RegQuality	0.4117826
Voice	0.3776139

The governance index used in the regression analysis is based on the first principal component extracted through Principal Component Analysis (PCA). This component captures the largest proportion of shared variation across the six Worldwide Governance Indicators (Rule of Law, Regulatory Quality, Government Effectiveness, Control of Corruption, Political Stability, and Voice and Accountability) and is interpreted as a composite measure of overall governance quality.

Appendix F. Financial Instruments used by DFIs

DFIs use a range of instruments to attract private investment into high-risk or underfunded markets. These tools aim to improve the risk-return profile of development projects and are central to blended finance strategies.

Guarantees reduce investor exposure to risks such as expropriation, currency controls, or borrower default. Political risk guarantees are commonly used in fragile or unstable environments. By covering potential losses, guarantees enable private lenders to finance projects they would otherwise avoid.

Concessional loans offer below-market terms, such as lower interest rates or longer maturities. These improve project bankability and help crowd in commercial finance by lowering overall risk. They are widely used in capital-intensive sectors like energy and infrastructure.

Equity investments involve DFIs taking ownership stakes in companies or projects. This signals confidence and shares risk with private investors. Equity is often used in growth sectors where commercial returns are expected, but may raise concerns about mission drift if concentrated in low-risk markets.

Syndicated loans allow DFIs to co-lend with private banks, typically as lead arrangers. Their involvement reduces information gaps and enhances project credibility. Syndications are common in large-scale infrastructure and corporate finance.

Technical assistance supports project preparation, regulatory reform, and institutional capacity. Though non-financial, it plays a key role in making investments viable and sustainable, especially in weaker institutional contexts.

These instruments form the operational toolkit of DFIs. Their effectiveness depends not only on financial design but also on the surrounding governance environment, as discussed in this thesis.

Appendix G. Online Repository

All data and code used in this thesis are available in a public GitHub repository:

Sunnemark, A. (2025). *Institutions Matter: Governance and the Role of DFIs in Mobilizing Private Investment*.

The repository includes:

- CSV files with cleaned governance and investment data
- Code used for regression models and visualizations

This repository is intended to support transparency and reproducibility, and may be cited using the format above.

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