Development finance in a mixed underdeveloped economy

Dr. Farwa Sial

Workshop: ***Development policy in a financially integrated world: Addressing contemporary challenges***

IDEAs- Chulalongkorn University Workshop

December 13-17, 2024, Chulalongkorn University, Bangkok

Lecture Outline

Session 1 & 2

Introduction to Development Finance
Differences between Commercial and Developmental Finance
Theory and History- Origins and Transformation
Financial Liberalisation and its impact
Multilateralism and International Development
Major Institutions of Development Finance.
Official Development Assistance (ODA) and where it stands today
Multilateral Development Finance-MDBs and Global transformations.
The promise and reality of Private Finance.
Where does Climate Finance fit?
Impact- why is development finance- not a source of transition from underdeveloped to developed?

What is Development Finance?

Development finance can be understood as a subset of economics comprising hypotheses and practices on how to efficiently allocate resources towards economic and social transformation (development) of nation states. By facilitating allocation towards social needs such as infrastructure, education and health, finance provided for developmental ends can address the failures or limitations of traditional financial institutions such as banks.

Aim of Development Finance: to achieve developmental outcomes that would not have happened without intervention.

Transformations of development finance: embedded in the transformation of economics as a discipline. An emerging consensus opposed and substituted the dirigiste model of post-colonial states and propagated a free market or neoliberal of economics.

In general, what distinguishes Development Finance from Commercial Finance is as follows:

Difference between Commercial and Developmental Finance in a mixed market economy

Commercial/Corporate Finance	Development Finance
Commercial finance emphasises the principles of risk and return. Funding of any economic activity largely depends on how risky the activity is and its ability to generate revenue.	Development finance considers other factors alongside risk and return. Social impact may be one. Development finance applies a wider lens, which means that key actors such as national, provisional, local and multilateral partners are more involved.
Commercial finance is mainly led by institutions like banks, asset managers and insurance companies.	Development funds provide more than just debt and equity capital. While financial institutions such as banks, insurance companies, investments companies and pension funds are also involved. The modalities of provision include concessionary loans, grants, sustainable financial instruments , project finance, and venture philanthropy, activism-based finances.

History as Theory – Origins of development Finance.

The very concept of development finance was born out of the challenge to promote the rapid economic transformation of countries.

- **Structuralism and 'Big Push' Hypothesis**

  Economic Commission for Latin America and the Caribbean (ECLAC), Emphasis on industrialisation.

- **Development Finance in Global North**
- **Options for Global South Countries:**
  - **Borrowing in Foreign Currency**
  - **Expanding Net Foreign Exports**
  - **Foreign Direct Investment (FDI)**
  - **Official Development Aid (ODA)**

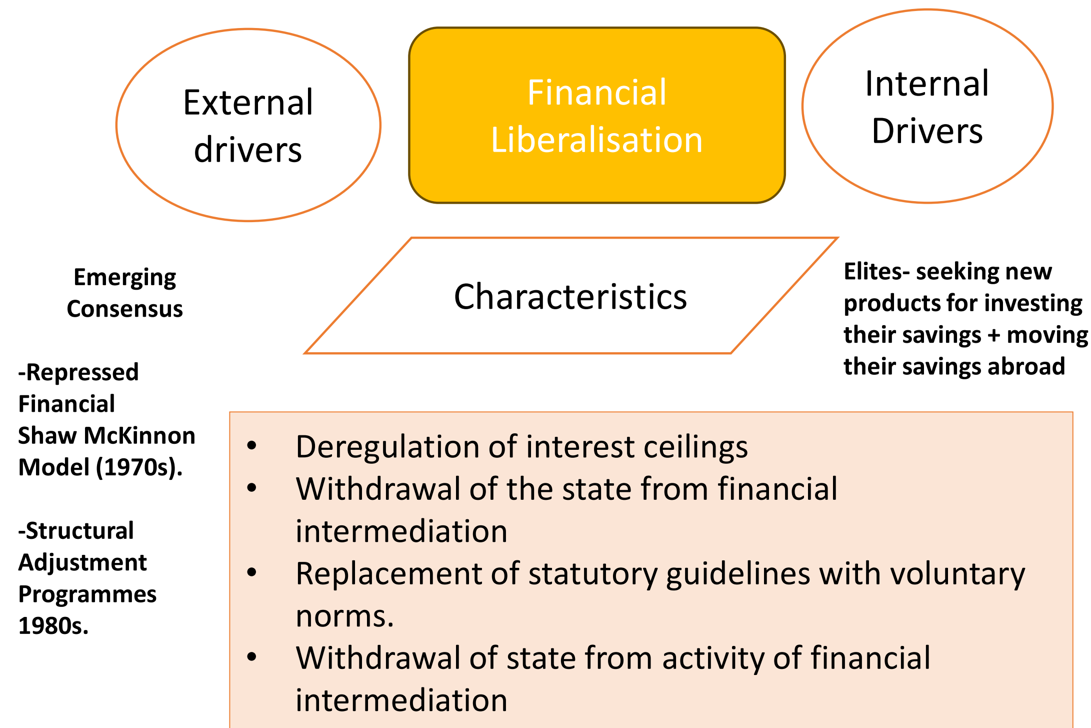
History as theory –Financial Liberalisation

Financial Liberalisation: the elimination of a series of impediments in the financial sector to align Global South countries with Global North financial markets.

Measures of liberalisation include diluting/dismantling regulatory control over institutional structures, instruments and activities of agents in financial sector.

3 types of financial liberalisation:

1. **Domestic financial sector reform-** privatization- increase in credit extension to private sector.
2. **Stock Market liberalisation-** country opens up its stock market to foreign investors, simultaneously as it allows domestic firms access to international financial markets.
3. **Liberalisation of capital account-** situation where special exchange rates for capital account transactions are relaxed, where domestic firms are permitted to borrow funds from abroad and where reserve requirements are lowered.



Impact of Financial Liberalisation

- **Regulative Escape:** Financial liberalisation increased the flexibility of banking and financial institutions when creating credit and making investments, and permitted the proliferation of institutions like hedge funds that, unlike the banks, were not subject to much regulation.

- **Growing financial consolidation:** This has concentrated financial activity and decision making in a few economic organisations and also integrated areas of financial activity earlier separated from another to ensure transparency and discourage unsound financial practices.

- **Dependency and Vulnerability of Global South Financial Organisation:** Prone to being embroiled in external crises

Impact on Development Finance- Examples.

Financial Liberalisation in Pakistan post 2004: Privatisation of commercial banks- high profitability in the post-2004 period.

- Closer look- profitability did not come from improved risk assessment ability or increased lending in productive sectors but reckless consumer finance lending, real estate and stock market speculation as well as risk-free investment in high yield government bonds.
- Stock markets soared -mid 2000s- **speculation offered a lucrative opportunity for banks- through direct investment in shares.** Stock market became a source of investor enrichment but not a source of productive lending to firms.
- Consumer finance was often used for real estate speculation and stock market speculation creating a bubble. The interlinked consumer finance, real estate and stock market bubbles burst in 2008, triggered by the State Bank of Pakistan raising interest rates in an attempt to counter the external environment which was turning unfavourable.

Less natural direction of change in the liberalisation of Indian financial sector

- Share of infrastructural lending in the total advances of scheduled commercial banks to industrial sector rose sharply. Sectors like steel, power, roads and ports and telecoms became most important beneficiaries.
- For commercial banks, which are known to prefer lending for short-term purposes, this turn to lending to infrastructure was a **high-risk strategy**.
- Failure to generate revenues needed to bear the debt service costs associated with their high debt to equity ratios led to defaults, even in cases where much effort at restructuring was made. Sharp increase in non-performing loans.

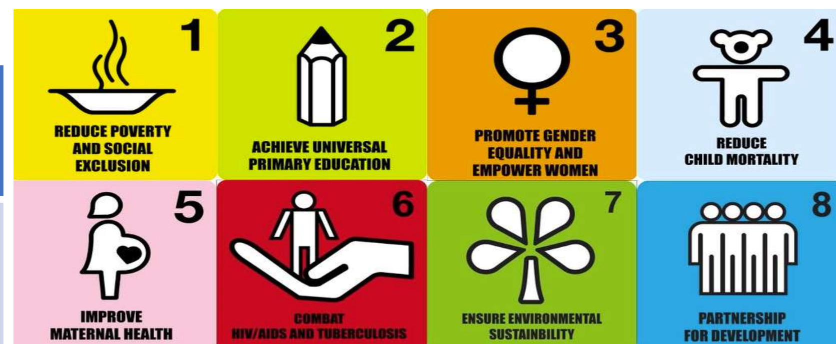
The Neoliberal transformation of Development Banking: the Indian experience, *C. P. Chandrasekhar*

Multilateralism and International Development Finance

- **From Millenium Development Goals to Sustainable Development Goals – what changed?**

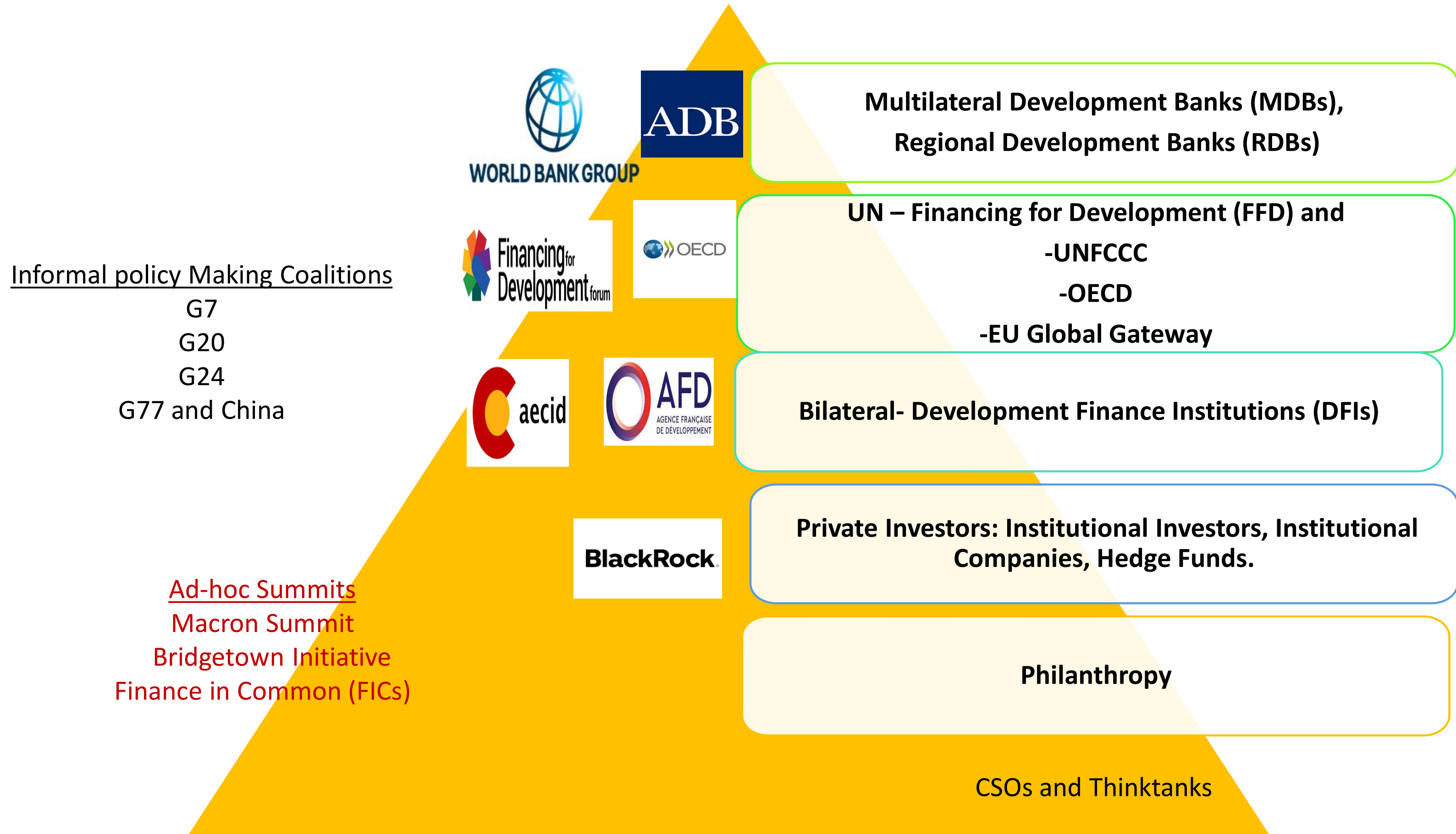
MDGs (until 2015) vs. SDGs (2030)	Critique
MDGs -UN experts ***SDGs- consultative process including 70 Open Working Groups, CSO,***	• Metrification of multifaceted but holistic human needs – fragmentation of finance into ad-hoc measures, including a central role of the private sector and private finance. • Combined with erosion of sources of patient finance + capital flight. • Emphasis on goals- pulled attention from alternative financing models- China
MDGs-8 goals, 21 targets **SDGs-17 goals, 169 targets.**	
MDGs- focus on developing countries. **SDGs all countries should focus.**	
MDGs - pillars of human rights **SDGs embedded in human rights.**	

Millenium Development Goals (MDGs)



Sustainable Development Goals (SDGs)

Major Institutions of Development Finance



The World Bank and the IMF

THE WORLD BANK **World Bank**	**International Monetary Fund (IMF)**
Origins: founded in 1944 to provide loans for building postwar Europe.	
Misson: Ending Poverty and ensuring shared prosperity	**Mission**: primary purpose- ensure stability of the international monetary system -the system of exchange rates and international payments that enables countries and their citizens to transact with each other. It does so by keeping track of the global economy and the economies of member countries, lending to countries with balance of payments difficulties, and giving practical help to members.
What does it do: issues loans and grants to low- and middle-income countries that it classifies as developing countries. Technical Assistance financing, policy advice, technical assistance to governments, + focuse on strengthening the private sector in developing countries.	**What does it do:** The IMF judges a country's financial state by looking at two main factors: its fiscal position—the size of the government's budget deficit and the amount of debt it has outstanding—and its balance of payments, or how much money is flowing in and out of a country. If a country is running out of foreign exchange reserves or otherwise needs help, the IMF typically offers a loan. The IMF also provides advice on how to structure economic policies, such as taxation and government budgets.

civilspedia.com

- **IBRD** – International Bank for Reconstruction
- **IDA** – International Development Association
- **IFC** – International Finance Corporation
- **MIGA** – Multilateral Investment Guarantee Agency
- **ICSID** – International Centre for Settlement of Investment Disputes

<u>Criticisms of the IMF and the World Bank:</u>

- Apolitical, technocratic or Engines of Western Capitalism?
- Purveyors of Global Knowledge – Mainstream-Neoliberal Economics
- Structural Underrepresentation of Global South Countries
- Policies which Undermine Democratic and Sovereign integrity of Global South Countries
- Impunity from Harm

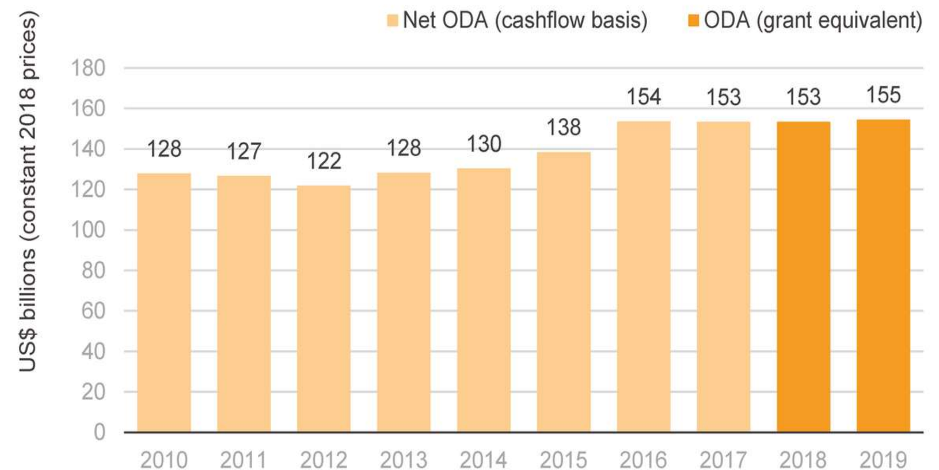
Putting Official Development Assistance (ODA) in context: Some Stylised Facts (Pre-Covid Assessment)

Scale: 1990s dramatic fall in aid effort. Aid reached US$60.9 billion in 1991 then fell to US$48 billion by 1997. Rapid increase in private flows since 1990. By 2004 aid restored to its real level of 1991 and by 2013 flows from DAC members started peaking until 2017.

Comparison with some other Spending and Flows:

a) EU donors spend billions a year subsidising their agriculture.(e.g €60 billion a year-2020).

b) Worker remittances to LDC are more than the value of aid (UN 2019)



Aid Harmonisation remains a challenge: Countries with Lowest HDI- ***not getting adequate aid (Burkina Faso, Burundi, Guinea)***
Top DAC recipient: India, Afghanistan, Syria, Indonesia, Jordan (2018-2019 Gross ODA)

Where does ODA stand today

Old OCED Definition: - Old OECD Definition of ODA (Provided by the official sector, main objective is economic development and welfare of recipient, concessional i.e. a grant element of at least 25%

ODA Modernisation Process – conducted by the OECD-DAC Working Party on Development Finance Statistics (WP STAT).

2018- process to modernize ODA as a measure of 'donor effort' initiated.

2023- agreement reached on rules for reporting Private Sector Instruments (PSI) as ODA equivalent.

- **private sector instruments (PSIs):** include loans, equity investments, mezzanine finance provided to private sector enterprises, and guarantees extended to financers who back them.

with the new rules it *has become much more complicated, layered and hard to track what is aid and what is not.*

For different types of PSI, rules were agreed with a view to:

a. establishing the ODA eligibility of PSI

b. establishing the grant equivalent basis of the different types of PSI

c. establishing the additionality of PSI

Aid to create the correct investment climate by addressing institutions and human capacity and enabling economic liberalisation. (Busan High Level Forum 2011). Brookings Institute 'Aid as a catalyst' (2011).

Realignment of the role of private sector with international development.

Shared aims- emergence of sustainable development goals (SDGs). New financing framework for development emerged in Addis Ababa at the FfD in July 2015.

Private Finance Modalities and Instruments: PPPs, Blended Finance, Private Equity, CSR.

The new Development Assistance agenda: contains an enhanced role of finance and focuses on mobilising private cross-border financial flows. The creation and deepening of financial markets has become an end in itself.

MDBs- Basic Overview

- MDBs have a public policy mandate- unlike commercial banks.
- MDBs are self-sustainable financial institutions that leverage governments' capital support by taking on debt in international financial markets.
- They take neither deposits nor have access to central bank funding, they heavily rely on market funding. MDBs issue bonds and securities purchased mainly by institutional investors (such as pension funds, commercial banks, insurance companies, and corporations worldwide) and governments. The funds obtained are used to finance medium to long-term finance to borrowing countries.

MDB	Type of Financing	Year Founded	Type of Borrower
International Bank for Reconstruction and Development (IBRD)	Non-concessional loans and Loan guarantees	1944	Middle-income government +some credit-worthy low income countries
International Development Association (IDA)	Concessional loans and grants	1960	Low-income government
International Finance Corporation (IFC)	Non-concessional loans, equity investment and loan guarantees	1956	Private sector firms in developing countries s
African Development Bank (AFD)	Non-concessional loans, equity investment and loan guarantees	1964	Middle-income governments, some credit-worthy low-income government and private sector in region

MDBs-Basic Overview – (b)

- The capital base of all MDBs includes the paid-in contributions and retained earnings**.**
- **Paid-in capital** represents the cash contributions made by government members during the successive replenishment of capital.
- **Callable Capital:** Also, member countries grant MDBs a guarantee to repay their obligations if needed called callable capital, and the member countries give it to MDBs to back up their bond issues.

How MDBs Operate

- Shareholders do not receive dividends for their capital investments (i.e., net income is fully retained), nor do they charge any fees for the callable capital used as a guarantee.
- **For donors,** the multilateral nature of MDBs entrenches a comparative advantage in allocating finance for development by helping mitigate the risk of investing in developing countries by themselves.
- **Borrowing members** also make a distinctive contribution to MDBs by granting a **preferred creditor treatment (PCT)** on their exposures.

Why the need for MDB Reform 2024

- **On demand side:** Borrower countries in need for grants and loans in priority sectors, technical support, policy advice. Post 2008- financial crisis- financing gap.
- Financial terms and conditions of MDB cheaper than what domestic and international capital markets could offer and its combination of financing, technical assistance and convening are 2 of key advantages of borrowing from MDBs.
- **Competitors of MDBs:**
- Commercial Finance (domestic and largely, international capital markets), traditional bilateral donors and emerging donors
- Private consulting and advisory companies.
- Even though lending from MDBs remain cheaper for many countries even at non-concessional rates-governments with market access often chose to borrow from slightly expensive capital markets to avoid conditionality on policies attached to MDB lending, loan processing time.
- Influence and pressure from Chinese Finance.

G20 MDB Reforms

- At the 3rd G20 Finance Ministers and Central Bank Governors (FMCBG) meeting in Bali on July 2024, the G20 launched the **report *"Boosting MDBs' investing capacity"*** on the Independent Review of Multilateral Development Banks' (MDBs') Capital Adequacy Frameworks (CAFs).

- In 2018, an external review by the G24 was done titled' **The Role of Credit Rating Agencies in Shaping Multilateral Finance Recent Developments and Policy Options'** It was supported by the G20 Eminent Persons Group. Implementation period of reform: 12-24 months.

- The expected potential scale of the increase: likely to be several hundreds of billions of dollars over the medium term. The increased lending capacity varies between MDBs and depends on the depth and scale of execution.

- Much depends on which **combination of reforms are pursued and how they are implemented**.

- **Risks:** ***'The reforms do have risks associated with them, but the Panel believes that these can be mitigated effectively. The risks are far outweighed by the dangers of not fully deploying the unique strengths of MDBs to help address the daunting development challenges that affect us all'.***
  - **G20 MDB Reforms are:**
  - Replacing governments and creating a hybrid model- enhanced notion of blended finance in MDBs.
  - Creation of new business- create business for private sector and provide new insurances
  - Role of World Bank: Increased influence of the bank. (Response in disaster: Pandemic Bonds).
  - Impact on developing countries- liberalisation and marketization of finance.

The promise and reality of Private Finance.

Rationale for Private Sector Finance

1. 'Financing Gap'
2. Risky Countries
3. Efficiency
4. Ability to Mobilise 'at scale'

Critique:

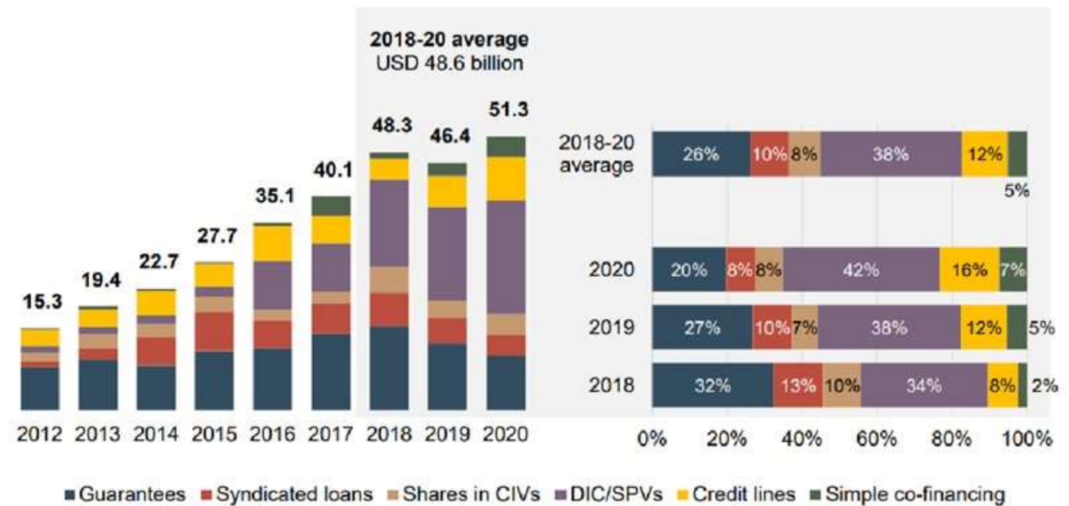
a) Linear Emphasis on Quantity and not on sources of Quality of Finance +Erosion of Domestic Capital base +Capital Flight

b) Risk-Returns.

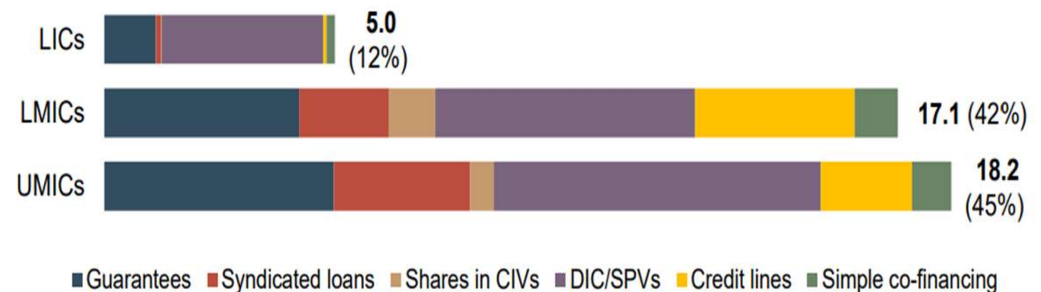
c) Returns based investment does not automatically equate with efficiency

d) OECD estimates show that in 2020, the total amount of private finance mobilised was US$51.3 billion

Mobilised private finance by leveraging mechanism, USD billion



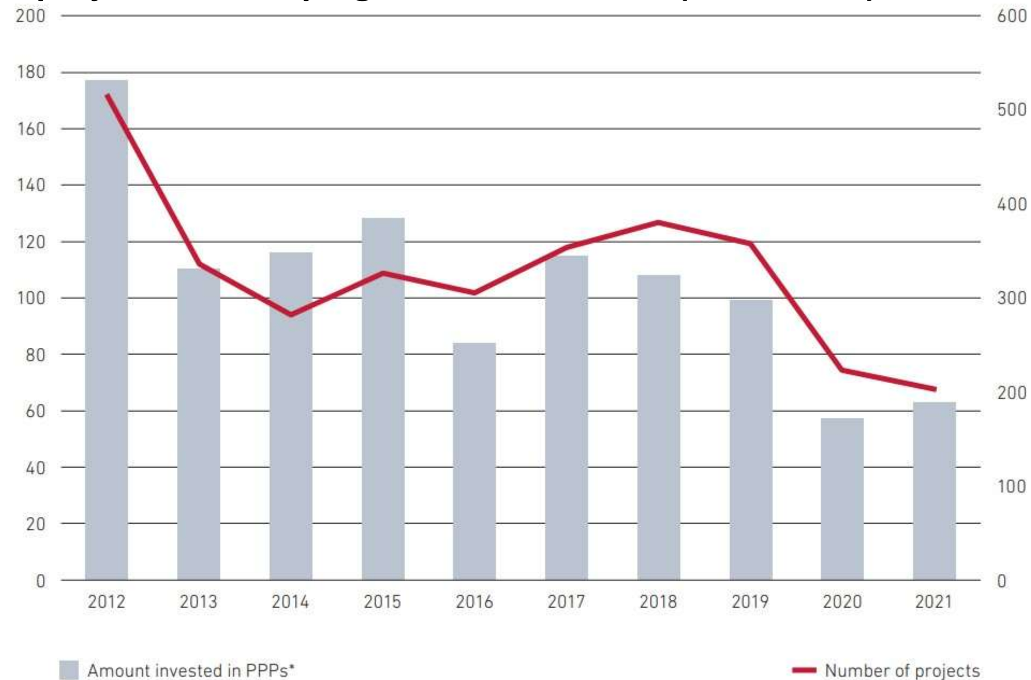
Mobilised private finance by income group, 2018-20 average, USD billion



Public Private Partnerships- PPP

What are PPPs?
PPPs are long-term contractual arrangements where the private sector provides infrastructure assets and services that have traditionally been provided by governments, such as hospitals, schools, prisons, roads, airports, railways and water and sanitation plants, where there is some form of risk sharing between the public and private sector.

Figure: Total investment in PPPs in infrastructure, and number of projects. Developing world, 2012-2021 (billion US$)



Problems:

1. Contingent Liabilities- hidden debt
2. Public Sector bears the risk
3. Expensive- higher costs
4. Quest for Increasing Profits- inevitably leads to cost cutting (foreign ownership)
5. Opacity-governance issues
6. Distorting public policy priorities.

Climate Finance

What is Climate Finance:

"Climate finance aims to reduce emissions, and enhance sinks of greenhouse gases, as well as reducing the vulnerability of, and maintaining and increasing the resilience of, human and ecological systems to negative climate change impacts." UNFCCC. *No consensus on definition.*

Mitigation finance consist of efforts aimed at limiting the effects of climate change by reducing the emissions of CO2 and other greenhouse gases (GHGs) from human-made sources into the atmosphere or enhancing the removal of GHGs from the atmosphere through carbon 'sinks'.

Adaptation finance is finance to adjust to the already apparent or expected consequences of climate change, such as sea-level rise, more frequent and extreme weather events, and changing crop growing seasons.

Loss and damage: term used by the United Nations to describe the negative consequences of climate change **that are not or cannot be avoided through adaptation or mitigation efforts**. Loss and Damage Fund was established (2022-COP 27). Operationalised 2023- COP28, pledges totalling just over US$700 million, the equivalent of less than 0.2 per cent of the losses suffered by countries in the global south.

United Nations (UN) Framework Convention on Climate Change (UNFCCC), in effect, 21 March 1994, is a convention that prevents "dangerous" human interference with the climate system.

Paris Agreement: legally binding international treaty on climate change, adopted by 196 Parties at the UN Climate Change Conference (COP21) in Paris, France, on 12 December 2015. Goal hold "the increase in the global average temperature to well below 2°C above pre-industrial levels" and pursue efforts "to limit the temperature increase to 1.5°C above pre-industrial levels."

New Collective Quantified Goal (NCQG)

Article 9 of this agreement affirms that "developed country parties shall provide financial resources to assist developing country parties with respect to both mitigation and adaption". The agreement also declared that a **New Collective Quantified Goal (NCQG)** on climate finance shall be set prior to 2024, from a floor of US$100 billion per year, accounting for the needs and priorities of developing countries

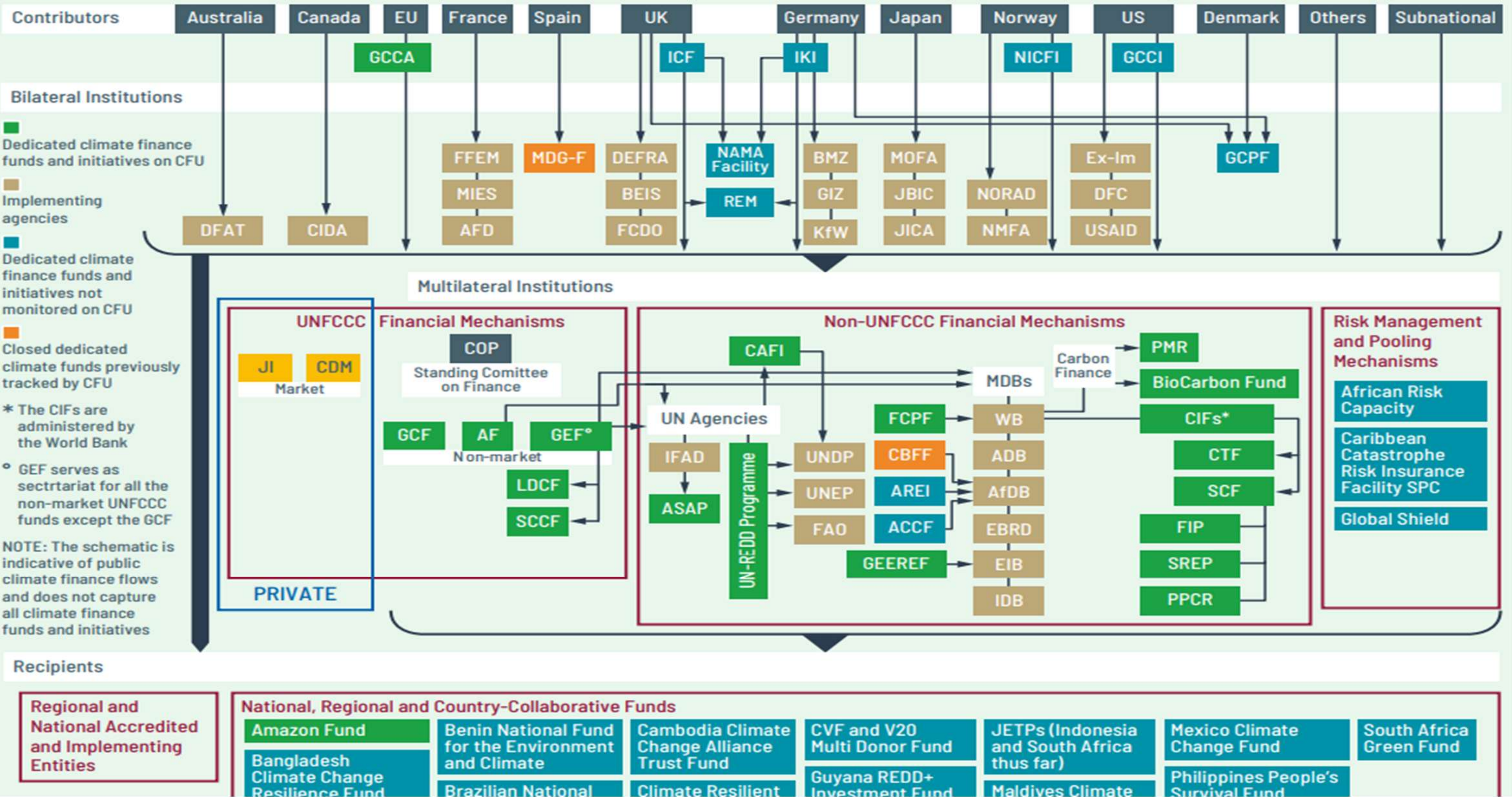


Figure 1: Global climate finance architecture
Contributors
Australia
Canada
EU
France
Spain
UK
Germany
Japan
Norway
US
Denmark
Others
Subnational
GCCA
ICF
IKI
NICFI
GCCI
Bilateral Institutions
Dedicated climate finance funds and initiatives on CFU
Implementing agencies
Dedicated climate finance funds and initiatives not monitored on CFU
Closed dedicated climate funds previously tracked by CFU
* The CIFs are administered by the World Bank
° GEF serves as sectrtariat for all the non-market UNFCCC funds except the GCF
NOTE: The schematic is indicative of public climate finance flows and does not capture all climate finance funds and initiatives
FFEM
MDG-F
DEFRA
NAMA Facility
BMZ
MOFA
Ex-Im
GCPF
MIES
BEIS
REM
GIZ
JBIC
NORAD
DFC
DFAT
CIDA
AFD
FCDO
KfW
JICA
NMFA
USAID
Multilateral Institutions
UNFCCC Financial Mechanisms
JI
CDM
Market
COP
Standing Comittee on Finance
GCF
AF
GEF°
Non-market
LDCF
SCCF
PRIVATE
Non-UNFCCC Financial Mechanisms
CAFI
UN Agencies
IFAD
ASAP
UN-REDD Programme
UNDP
UNEP
FAO
FCPF
CBFF
AREI
ACCF
GEEREF
MDBs
WB
ADB
AfDB
EBRD
EIB
IDB
Carbon Finance
PMR
BioCarbon Fund
CIFs*
CTF
SCF
FIP
SREP
PPCR
Risk Management and Pooling Mechanisms
African Risk Capacity
Caribbean Catastrophe Risk Insurance Facility SPC
Global Shield
Recipients
Regional and National Accredited and Implementing Entities
National, Regional and Country-Collaborative Funds
Amazon Fund
Bangladesh Climate Change Resilience Fund
Benin National Fund for the Environment and Climate
Brazilian National
Cambodia Climate Change Alliance Trust Fund
Climate Resilient
CVF and V20 Multi Donor Fund
Guyana REDD+ Investment Fund
JETPs (Indonesia and South Africa thus far)
Maldives Climate
Mexico Climate Change Fund
Philippines People's Survival Fund
South Africa Green Fund

UN Climate Change Conference (COP29) Nov 2024- What happened?

- Previous goal 100 bn USD per year- arbitrary. Claim by Developed countries that this had been achieved in 2022. In reality 75% was in loans.
- COP 29- 'Finance COP'- New finance goal: Triple finance to developing countries, from the previous goal of USD 100 billion annually, to USD 300 billion annually by 2035. New commitment is expected to come from a combination of public, private, bilateral, multilateral, and alternative sources, as outlined in the final agreement.

However:

- Demand by Global South countries: annual transfer of $1.3 trillion- of which $600 in grants/ concessional loans.
- Mobilisation vs. Provision.
- The 300 billion annual commitment includes MDB contribution- including that by Global South countries (as shareholders of MDBs)
- Goal does not account for inflation. Next review 2035.

Sanctions and Development Finance- where do they converge?

<u>What are Sanctions?</u>

-Economic and political measures that aim to influence the behaviour of a state, a group or individuals.

'*Enforce international law, maintain or restore peace and security, and compel states or entities to comply with UN decisions'* - United Nations Security Council (UNSC).

Sanctions could be multilateral (UN), bilateral (EU, individual countries).

IMF excludes the membership of certain highly sanctioned countries.

. Regional-South- South cooperation hampered – Sanctioned countries cannot trade with non-sanctioned countries.

Impact- why is development finance- not a source of transition from underdeveloped to developed?

- Post-Financial Liberalisation: Policy Space for Global South countries.
- ODA- inadequate but also not transformational- even more constrained with Private Sector Instruments.
- G20 MDB Reforms-
- Private Finance Mobilisation- Inadequate, concessional but still interest bearing therefore contributors to debt.
- Climate Finance, inadequate.

Resources

International Development Economics Associates IDEAs Website

1. **The 'Billions to Trillions' charade** *Jayati Ghosh* https://www.networkideas.org/news-analysis/2024/05/the-billions-to-trillions-charade/
2. **Open Veins of Africa Bleeding Heavily** *Ndongo Samba Sylla and Jomo Kwame Sundaram* https://www.networkideas.org/news-analysis/2022/11/open-veins-of-africa-bleeding-heavily/
3. **The COP29 Collapse** *C. P. Chandrasekhar and Jayati Ghosh* https://www.networkideas.org/featured-themes/2024/11/the-cop29-collapse/
4. **G20 must end "outsourcing" of multilateralism** *Charles Abugre and C.P Chandrasekhar*

- **Developing Economics A Critical Perspective On Development Economics. Blog**

(Search 'Development Finance')