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BRIEFING

Commercial finance for development: a back door for financialisation

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SUMMARY
The global Covid-19 pandemic has accelerated a trend under way for the last decade: the enlistment of private-sector commercial finance for development. This finance can be brought in through (1) regular cross-border flows, (2) blended finance and (3) impact bonds. This briefing argues that intensified foreign financial inflows are likely to draw African economies further into financialisation, which increases financial instability and can undermine the democratic process, jeopardising just socio-economic development. Specifically, the short-termism of portfolio flows requires costly reserve accumulation, foreign direct investment exposes firms to demands for shareholder value generation, and external debt introduces exchange rate risk for domestic borrowers.

KEYWORDS
Finance for development; financialisation; impact bonds; blended finance; foreign financial inflows

Introduction

The global Covid-19 pandemic has accelerated a trend in development finance that has been under way for the last decade: the enlistment of private-sector and commercial finance for development. Conceptually, commercial finance can be brought in for development through (1) regular cross-border flows; (2) blended finance arrangements that aim at fuelling additional investment by reducing risk to private financiers; and (3) impact bonds in which private investors lead on design and delivery of policy interventions. Since domestic fiscal demands on rich countries are expected to reduce official development aid (ODA) commitments going forward,[1] the turn towards private-sector finance might appear logical. These trends are particularly relevant for the African continent, where financing needs are vast and foreign investment remains modest in international comparison (Soulé 2020). But taking a closer look at the consequences of foreign financial inflows provides a more sobering picture. There are three main types of foreign financial inflows: portfolio equity investment, foreign direct investment (FDI) and foreign debt. The short-termism of portfolio flows requires costly reserve accumulation, shifting resources from the public to the private sector; FDI changes corporate behaviour and exposes firms to demands for shareholder value generation; and external debt introduces exchange rate risk for domestic borrowers. Thus, calling for more

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private-sector finance to stem the lack of ODA for development is likely to draw African economies further into financialisation. This could jeopardise just socio-economic development since financialisation has been documented to increase financial instability and socio-economic insecurity in developing countries (Bonizzi 2013), while undermining the democratic process once it affects public policy and institutions (Karwowski 2019).

This briefing proceeds as follows: the following section, titled ‘New financing for development’, summarises major trends in international policy around new initiatives for financing development. The third section, ‘From foreign financing to financialisation’, provides a critical assessment of the specific ways in which commercial finance is typically involved in funding development, revealing how they tend to introduce financialisation into developing and emerging economies. The final section concludes, pointing towards policy alternatives.

New financing for development

Ideas to join private and public sector resources to fund development are not new. In the current policy discourse, there are, broadly, three conceptually different approaches to strengthen the role of private, and especially commercial, finance for development. First, international financial flows are increasingly labelled as drivers of development, especially FDI and investment linked to value chain integration. Thus, the idea is to encourage these cross-border flows with minimal changes to existing policy frameworks, in the hope that they will (re)align with the development process in poor countries, and especially with the Sustainable Development Goals (SDGs). Second, so-called blended finance, referring to arrangements in which public resources ‘de-risk’ investment for private-sector commercial financiers, is promoted as tool to crowd in additional private funding on the back of ODA.[2] Here, the intention is to simply increase the volume of funds available for development purposes, with governments and official donors shouldering risk to make involvement more attractive for commercial finance. Third, financial instruments that are principally led by private-sector investors, most notably development or social impact bonds (DIBs and SIBs), are promoted with the aim to enlist business beyond mere financing, allegedly harnessing private-sector management skills and innovative capacity. In the case of DIBs, private-sector entities are meant to fund, design, implement, monitor and innovate policy interventions, while carrying the project risk, since they only recuperate their investment from the public institution that commissions the project in the event of success. In all three cases, external financial inflows into developing countries are encouraged.

Major international support for a more prominent role for private finance emerged in response to the global financial crisis (GFC). The United Nations (UN) intensified their efforts to attract private financiers into development through the Finance for Development (FfD) process that started in 2002 with the International Conference on FfD in Monterrey. The second conference was held at the end of 2008 in Doha when the global character of the GFC was becoming fully apparent. This was quickly followed by an event on the ‘World Financial and Economic Crisis and Its Impact on Development’ in June 2009 in New York. The overall outcomes were the Doha Declaration, calling for a mobilisation of private-sector financial resources for development, and an institutionalisation of the FfD process. Thus, the response to the GFC that shattered

international financial markets due to financiers' greed and speculation was proclaimed to be more finance rather than less.[3] There is a historical continuity to failed financial development policies simply mutating rather than being fundamentally reviewed. For example, during the 1990s the policy dialogue shifted from the financial repression hypothesis, claiming that financial liberalisation would generate more saving and investment through higher interest rates, to financial deepening, stating more broadly that financial-sector development was good for growth (Karwowski and Stockhammer 2017). More recently, the financial inclusion agenda has given a new moral rationale to microfinance, whose effectiveness in reducing poverty is doubtful given empirical evidence (Bateman, Blankenburg, and Kozul-Wright 2018).

Today, there is a plethora of international initiatives, reports and, increasingly, agencies that deal with mobilising private finance for development. Principally, FfD efforts are led by the UN's Financing for Sustainable Development Office (FSDO) and, since 2015, following the Third International Conference on FfD in Addis Ababa, an Inter-Agency Task Force bringing together more than 60 international agencies including major international financial institutions under the lead of the UN Department of Economic and Social Affairs (UN/DESA). A Financing for Sustainable Development report has been published annually since 2016 (UN 2020). Those reports advocate strengthening private-sector financial flows to developing countries, especially FDI and investment linked to global value chain integration.

Similarly, blended finance and impact investment have been promoted internationally over the past decade. The term 'impact investment' refers to a broader phenomenon than impact bonds, defined by its 'intention to generate positive, measurable social and environmental impact alongside a financial return' (GIIN 2020, 74). Given the vagueness of this definition and the focus on financial returns, the promotion of impact investment seems an exercise in redefining regular financing activity as impactful, a strategy often adopted by philanthrocapitalist endeavours (see, for instance, Giridharadas 2018). The fact that GIIN, one of the major organisations publicising impact investment by 'measuring' the phenomenon's growth, is effectively a network of financial investors supports this view. Hence, this briefing focuses on impact bonds while impact investment more broadly, if focused on development, is also covered since it would fall into either the FDI or the portfolio inflows category.

In 2013, the UK government, leading the inter-governmental Group of Eight (G8) at the time, announced the establishment of the G8 Social Impact Investment Taskforce to promote impact investing for social and developmental purposes (Dowling 2017). While the G8 was a relatively short-lived international forum, disappearing as relations between Russia and the US plus Western Europe soured, SIBs have been increasingly utilised for social provision, especially in the UK and US but also across Europe, in Australia and in South Korea (OECD 2016). So far, most impact bonds have been issued in rich countries. At the end of 2019, only 17 of 173 existing impact bonds were issued in developing countries. The majority of these (nine out of 17) targeted African societies (Gustafsson-Wright, Boggild-Jones, and Nwabunnia 2019).

A similar trend has been identified for blended finance. The Organisation for Economic Co-operation and Development (OECD) and the UN Capital Development Fund launched an annual report on Blended Finance in the Least Developed Countries (LDCs) in 2018. The 2019 report laments that ODA to LDCs, and particularly 'Africa',

fell in real terms since 2017. Thus, 'there is increasing focus on how limited public resources can be used to put in place the right incentives and regulations to mobilise private finance for the SDGs' (OECD/UNCDF 2019, 16). The global epidemic and its economic fallout have prompted a similar international response, with the UN calling for policy action to sustain foreign investment into developing countries, '[r]eversing the decline of FDI, revitalizing global supply chains', and mobilising 'sustainability-themed funds, including pension funds, sovereign wealth funds, private equity funds and impact investment' (UNCTAD 2020, 3).

The proposition that waning ODA receipts in poor countries and especially on the African continent can be propped up with commercial financial flows is convenient to policymakers but also rather simplistic. It appears that the impact and effectiveness of instruments labelled as blended finance and impact bonds are vastly overstated. For instance, the majority of blended finance arrangements rely on government guarantees, reducing investment risk for commercial financiers, while mainly flowing into the banking sector (especially to commercial banks and microfinance institutions)[4] and infrastructure projects (particularly energy infrastructure) (OECD 2020). Thus, the amount of 'additional' private-sector resources that these tools are able to leverage appears rather meagre, potentially going for projects that would have been commercially attractive regardless of official support (Bayliss et al. 2020). Impact bonds, in turn, have been criticised for being too complex and costly to set up and therefore impractical in the development context where administrative capacity and funds are scarce (Roy, Neil McHugh, and Sinclair 2018). These criticisms aside, the desired overall result of policies promoting commercial finance for development is an increase in foreign financial inflows to poor countries.

Therefore, the next section discusses how financial inflows, far from being unproblematic, can in effect introduce financialisation into developing countries' economies and societies. I will use the example of South Africa, the African economy hosting, at its peak in 2007, one-third of all foreign liabilities on the African continent.[5] Most generally, financialisation refers to the process that increases the 'role of financial motives, financial markets, financial actors and financial institutions in the operations of the domestic and international economies' (Epstein 2005, 3). While a healthy and strong finance sector is crucial to support investment and employment creation, financialisation researchers highlight the detrimental consequences of an excessively large and powerful financial sector on economy and society. Across OECD countries financialisation has been shown to have had a strong and detrimental impact on income distribution and employment (Assa 2012), while undermining workers' bargaining power and labour protection (Darcillon 2015).

In the context of developing countries, financialisation is 'a type of structural transformation through which productive structures lose out or become subordinated to financial accumulation' (Karwowski 2020a, 121). In such poorer economies, unlike in the rich core, financialisation tends to be introduced through external forces, even though often welcomed and actively invited by parts of domestic capital (see Freund 2013 for the South African example).[6] Hence, especially in emerging economies, for which there tends to be more and better data coverage, financial liberalisation has been shown to reduce capital expenditure in favour of financial investment (Demir 2009), cross-border financial flows are documented to influence the wage share

negatively (Stockhammer 2017), and global liquidity has been found to shape booms and busts in domestic credit cycles (Rey 2015). Thus, far from supporting development, a dominant, excessively large financial sector can undermine economic growth and transformation. Foreign financial inflows fuel this process, while instruments such as impact bonds undermine the democratic character of public policy by reducing social provision to a by-product of investment.

From foreign financing to financialisation

Historically, South Africa has been the economy that has attracted most foreign inflows on the African continent. The country developed on the back of rich mineral deposits whose extraction was mainly financed by European capital. South Africa's relatively deep and developed financial markets make it an attractive destination for cross-border financial flows, including investment into portfolio equity. Equally, South African companies have been eager to tap foreign financial markets, with some of the largest corporations, like Anglo American, moving their headquarters to London in the early 2000s (Chabane, Goldstein, and Roberts 2006). Portfolio flows are typically short term in character, meaning they tend to be withdrawn within a year, since investors are in pursuit of profit rather than control. Officially, equity investment that amounts to less than 10% of company value constitutes portfolio investment, while anything at or above that threshold counts as FDI (IMF 2013). Given the drive to liberalise financial accounts that took hold of the continent in the 1990s, cross-border flows can move in and out of African economies increasingly easily. Extremely easy monetary policy in rich countries in response to the GFC – that is, quantitative easing – have further fuelled these flows. In South Africa, portfolio investment accounts for around one-third of inflows into the country, while the figure is lower for other African countries.[7] Nevertheless, specific African economies including Mauritius, Kenya, Nigeria and Ghana have lately seen sharp increases in portfolio inflows, making the South African experience relevant going forward.

Between February and July 2020, in response to the pandemic, foreign investors withdrew much of their portfolio investment from the continent. South Africa suffered the largest outflow, exceeding 2% of its gross domestic product (GDP; IMF 2020a). This happened despite the country's reputation for orthodox, and in International Monetary Fund (IMF) terms 'prudent', macroeconomic policies. Part of the needed policy in developing economies is the accumulation of foreign exchange reserves to stem any sudden portfolio outflows. With increased levels of financial liberalisation, developing countries across the globe have raised their reserve holdings substantially. While developing economies held, on average, 12% of GDP in reserves during the 1990s, reserves exceeded one-fifth of GDP after the GFC (2008–2013). Oil- and gas-exporting economies – countries with large foreign exchange receipts – went even further, more than tripling their reserves from 8% to almost 30% of GDP (McKinley and Karwowski 2015). However, reserve accumulation is costly, and the subsequent monetary sterilisation of foreign inflows– that is, central banks' issuance of domestic bonds to 'drain' any 'excess' liquidity in the local market – fuels financialisation. How so?

Let us assume that in response to an inflow of investment into the Johannesburg Stock Exchange (JSE), the South African Reserve Bank (SARB) purchases Treasury Bills issued

by the US Federal Reserve (T-Bills). These are short-term, highly liquid instruments with a maturity of up to one year. In 2019, SARB would have received a return of around 1.5% on T-Bills with a maturity of three months and up to 2.5% for one-year instruments.[8] The inflow into the JSE creates an equivalent amount of South African rand. Now the fear is that because of growing money supply, inflation might rise. In fact, inflation is a more complex phenomenon, but monetarist ideas focusing on money supply still dominate exchange rate transactions. Thus, the SARB gets to work with the aim to 'drain' additional rands by issuing SARB debentures – that is, domestic government bonds. In 2019, the interest on 91-day debentures was just over 7%, meaning the cost of reserve accumulation and sterilisation was somewhere between 4.5% and 5.5%. This interest rate spread, always disadvantageous for poor countries, is caused by the US dollar's top position in the international currency hierarchy: whenever there is a crisis, international investors take refuge in the most liquid currency, the dollar. As a result, from mid 2007 to mid 2009 alone, sterilisation and reserve accumulation cost the SARB more than R5 billion (Brink and Kock 2010). Consequently, reserve accumulation transfers resources from poor to rich countries and from the public sector to private financiers. In the global South, financial inflows generate lucrative investment opportunities for private investors since sterilisation results in government bond issuance. These bonds are relatively safe and profitable, competing with returns on productive operations. This opens the route to financialisation for domestic companies, meaning towards a shift from productive activity to financial investment. Government bonds issued to sterilise inflows are sometimes so lucrative that their profitability undermines the sterilisation process, attracting further inflows (Lee 1997).

Nevertheless, reserves might not be sufficient to stem large portfolio outflows, as for instance caused by the global pandemic. In July 2020, South Africa had to request emergency financial assistance from the IMF for the first time since its transition to democracy in the 1990s. It drew down 100% of its special drawing rights with the IMF, equating to US$4.3 billion. This regular drawdown had no policy conditionality attached (IMF 2020b). For countries already indebted to the IMF, the Catastrophe Containment and Relief Trust (CCRT) has been set up to support debt servicing in response to the pandemic. Nineteen of the 25 countries that have requested assistance are African economies. While there is no policy conditionality attached to the CCRT at the moment, the IMF reserves the right to introduce conditions in future (IMF 2020c). Conditionality calling for further financial liberalisation, or the introduction or strengthening of inflation targeting – the latter was the case in a recent IMF loan to Ukraine (IMF 2020d) – can put domestic governments under pressure to implement the described sterilisation policies, ushering in financialisation by creating opportunities for financial accumulation at the expense of production.

FDI, despite its more long-term character, can also introduce financialisation practices and pressures. For instance, in Latin America and Central Eastern Europe the entry of US and Western European banks has substantially changed local lending patterns. Under financialisation, banks tend to increasingly focus on consumer lending and mortgage finance alongside fee-generating activities. In both regions, a shift towards more household lending has been observed (Gabor 2010; dos Santos 2013), weakening the contribution of bank credit to structural transformation through the support of high-value-added or employment-intensive industries. A similar shift in lending is discernible

among South African banks. Since the 1990s, manufacturing credit as share of overall lending shrank dramatically with the bulk of loan expansion going to households alongside the financial, insurance and real estate sectors. Thus, instead of supporting manufacturing production, jobs and exports, South African banks have fuelled unsustainable consumption spending and house price inflation (Karwowski 2018). Since the four dominant South African banks have spread across the African continent over the past two decades, they might reproduce these lending patterns in other African economies, failing to support local manufacturing.

The integration into global supply chains often includes an element of portfolio investment or FDI, as firms become increasingly exposed not just to global production chains but also to international finance. As a consequence, locally listed firms become exposed to demands for shareholder value (SHV) generation – that is, the need to pay handsome dividends while keeping share prices high. Pressure to generate SHV is a central aspect of financialisation since placating shareholders tends to happen at the expense of production and job creation (Demir 2009), resulting in short-sighted and often unsustainable investment strategies, as exemplified in the South African platinum industry. Efforts to deliver SHV during the commodity boom of the early 2000s led to large dividend distributions, rising debt and aggressive capacity expansion. As the cycle turned major, South African platinum miners were left with excess capacity and financially fragile, which subsequently exacerbated distributional conflicts between management and organised labour (Bowman 2018).

The third major type of financial inflow to African economies is foreign borrowing, which for poor countries almost always means borrowing in US dollars. Exchange rate volatility, a result of financial liberalisation and floating exchange rate regimes, makes borrowing in foreign currency risky, especially in a financialised setting where emerging market currencies have become popular investment assets (Kaltenbrunner and Painceira 2017). For governments outside the core rich countries, international borrowing can generate financial incentives to embrace policies that fuel currency volatility, and financialisation more generally, such as the persistent absence of regulation to the capital account. Foreign inflows have been shown to stabilise the long-term price of South African government bonds. Thus, occasional crises and corporate capital flight are tolerated by political elites in exchange for favourable terms of access to international capital markets, constituting resources for distribution to their popular base through subsidies and targeted expenditure programmes (Ansari 2016). If foreign inflows are potentially undermining development by introducing financialisation, should developing countries instead turn to impact bonds, financing specific development projects?

DIBs and SIBs are even more problematic, fundamentally undermining the democratic character of public provision. Here, the contractor, in a SIB the domestic government and a donor for a DIB, identifies a public good or service that is missing. A financial company structures the bond and monitors service delivery. The private investor provides funding up front and is repaid with interest when the identified good or service is delivered successfully by a private (often not-for-profit) provider according to a measurable performance target. The creation of impact bonds constitutes a deep structural transformation of public policy, since delivery of public services is turned into the basis for financial instruments and accumulation. For social provision, the need to accommodate the parameters of a tradable financial asset often means a shorter

running period and socially problematic but measurable aims (Dowling 2017). DIBs/SIBs transfer resources from the public to private investors. Most fundamentally, they remove social provision from democratic decisions and scrutiny into the realm of financial markets (Roy, Neil McHugh, and Sinclair 2018). This is particularly problematic for poor countries that still need to roll out much of their social services and societies in which democratic and civil society institutions are only emerging or weak. Even in economies with long-standing and arguably strong democratic traditions, handing control to financial markets has undermined democratic processes (Karwowski 2020b).

Conclusion and alternative policies

The conclusions of this briefing are rather pessimistic: portfolio flows put pressure on African governments' resources through the need to hold reserves in anticipation of their withdrawal while creating opportunities for financial accumulation; FDI and value chain integration can usher in financialised practices; and foreign debt can entrench exchange rate volatility. All three of these pressures undermine production and job creation. Financial instruments that are led and designed by financial investors, such as DIBs, hollow out the very essence of social provision, the idea that public goods and services are available to citizens because of a democratic policy consensus rather than as a by-product of investment. Thus, it is questionable whether commercial finance should be directly involved in funding development at all. Rather, rich countries should step up to the commitment of providing 0.7% of their national income as ODA, especially since governments of rich countries can currently borrow at historically low prices.[9] As for commercial finance, the sector can support resource mobilisation for development by paying tax rather than facilitating tax avoidance and evasion. Estimates suggest that 40% of multinational profits is shifted to tax havens each year. Almost one-third of these flows originate in developing countries. Thus, in 2015, developing countries are estimated to have missed out on US$185 billion (Tørsløv, Wier, and Zucman 2020). This lost tax revenue is worth twice as much as annual financial inflows into all African economies together.[10] Furthermore, finance, especially in the guise of international banks, auditors and accountants, currently plays a major role in facilitating capital flight from developing countries (Open Secrets and Shadow World Investigations 2020). International cooperation among governments to effectively sanction international finance would be necessary to reach this goal. The UN seems to be aware of this challenge judging by the cursory mention of international tax cooperation and illicit financial flows in the Finance for Sustainable Development reports. These issues, rather than FDI, blended finance and impact bonds, must take centre stage if we are serious about financing development. Meanwhile, the growing interest among financiers in 'financing' development should be approached with caution and a fair share of scepticism. Despite philanthropic rhetoric, their main interests are generating profit and keeping their clients happy, rather than the just socio-economic development of poor countries.

Notes

1. For instance, the UK halved its budget for aid to Yemen in March 2021 (Wintour 2021).

2. There is a range of definitions for blended finance. However, the term is increasingly employed to describe financial instruments that use public resources to bring in private commercial funds (Attridge and Engen 2019).
3. On the role of banks, and finance more broadly, in the global financial crisis and the subsequence sovereign debt crisis in the Eurozone see Tooze (2018).
4. Microfinance institutions (MFIs) are major beneficiaries of blended finance and would deserve a more in-depth discussion in this context. Unfortunately, there is very limited information of how these usually play out or what share of banking sector projects involve MFIs. The OECD mentions MFIs, alongside commercial banks, as major beneficiaries of blended finance. There is also some data generated by private-sector investors (usually financial companies that specialise in promoting blended finance tools). Given the commercial character of these companies and their interest in portraying blended finance as success, the figures seem rather unreliable. Hence, further research is required in this area.
5. Author's calculations based on Lane and Milesi-Ferretti (2017).
6. Research (and especially the concept of subordinated financialisation) sometimes downplays the importance of domestic finance and other interest groups in the promotion of financialisation. However, the growing literature on variegated financialisation stresses the role of domestic agents and institutions, including the state, in the process (see, for instance, Karas 2021).
7. Averaging 9% during the 2000s.
8. The SARB holds part of reserves in liquid instruments and part in higher yielding (up to 3% in 2019) long-term investment (US Department of the Treasury 2020).
9. In early 2021, Germany and France could issue 10-year government bonds at negative interest rates while the equivalent UK gilts rate stood at 0.37% (OECD 2021).
10. Average value for 2000–2015.

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