UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
UNCTAD

Intergovernmental Group of Experts on

FINANCING FOR DEVELOPMENT

THIRD SESSION

4–6 November 2019
Palais des Nations, Geneva

UNITED NATIONS
UNCTAD

Blended finance as finance for development: Lessons from 40 years of financial transformation?

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An unmet need for financing for development

- The Addis Ababa Action Agenda, 13-16 July 2015, set Financing for Development goals: 'promoting inclusive economic growth, protecting the environment, and promoting social inclusion.'
- There is however a huge funding gap in meeting targets for the SDGs and for the 2015 Paris Accords on carbon targets.
- ODA funds are too small to fill these funding gaps.

Can blended finance fill this gap?

- Blended finance as currently defined leverages risk-absorbing public funds to attract private capital.
- So the key is the use of securitization – the bundling of individual project loans into vehicles that can be bought by financial funds.
- It has not been scaled up: we need US$2.5T/year to meet SDGs - 3% of global GDP (UNCTAD).
- But blended finance has raised less than US$1B, a small fraction of all credit raised for the non-financial sector in recent years.
- Far too little!

UNCTAD (2017) identified a space for blended finance

Report of the First Session of the Intergovernmental Group of Experts, November 2017:

‘22. Stresses that, while blended finance instruments can serve to lower investment-specific risks and incentivize additional private sector finance across key development sectors led by regional, national and subnational government policies…, careful consideration should be given to the appropriate structure and use of blended finance instruments to ensure that projects involving blended finance… should share risks and rewards fairly, include clear accountability mechanisms and meet social and environmental standards;

‘23. Emphasizes the need for a common understanding of blended finance to serve as a basis for a transparent and clear reporting system’

The three-tier blended-finance system-in-waiting

- So it has to get bigger in scale, but will this be done in 'the right way'?
- Since 2017, planning for blended finance has moved on, and a three-tier system is now planned. Its intended architecture is set out in the October 2018 report by the G20 Eminent Persons Group, *Making the global financial system work for all*. This three-tiered system would contain:
  - At the top, the IMFS – the IMF's board – should maintain control and surveillance over the system.
  - The IFIs should coordinate their efforts, and shift from loan making to loan guarantees and underwriting. Multilateral development banks should do the same.
  - Then loans would be made and securitized on a local basis, funding the actual projects.

The upshot: securitization has to be scaled up to provide finance for development.

Judith Tyson's August 2018 ODI report summarizes the needed steps:

1. Re-orientate international financial institutions (IFIs) to adopt 'originate-to-distribute' business models and focus on project development.
2. Deliver more 'bankable' projects by developing capacity for 'state-of-the-art' national infrastructure planning and execution.
3. Develop syndication and securitisation, using 'mega-funds' as a key financing model to crowd in institutional investors.
4. Deliver affordable foreign exchange (FX) and political risk hedging by scaling up existing successful IFI seed-funded providers.
5. Deepen pension and life-insurance markets in domestic economies to deliver local currency financing of infrastructure

The core financing vehicle has been in use since the 1980s, and is linked to several serious financial crises.

- So you make blended finance bigger by standardizing it.
- It thus seems that development finance is finally modernizing – making the switch from 'bank-based' to 'market-based' credit (in Perry Mehrling's term).
- But this is not new. Securitization has been used to augment bank lending, especially from the 1980s.
- The institutions for hedging risk and scaling up lending into tradeable securities already exists, and those controlling those institutions do not want to share their fees.
- Let's examine the history of the last 40 years here.

Latin American debt crisis and Brady Bonds

- US and other big banks made huge loans to Latin American countries in the late 1970s and early 1980s, based on a commodity boom and home-market troubles.
- Recession, aggressive US monetary policy, and collapsing commodity prices led to Mexican loan default in August 1982, followed by the default of other nations in Latin America.
- US money-center banks' Latin American loans exceeded their capital.
- Brady Bonds were created by taking loans off banks' balance sheets, with contributions from the US Treasury and home governments.
- 11 US banks were declared 'too big to fail' in 1994.

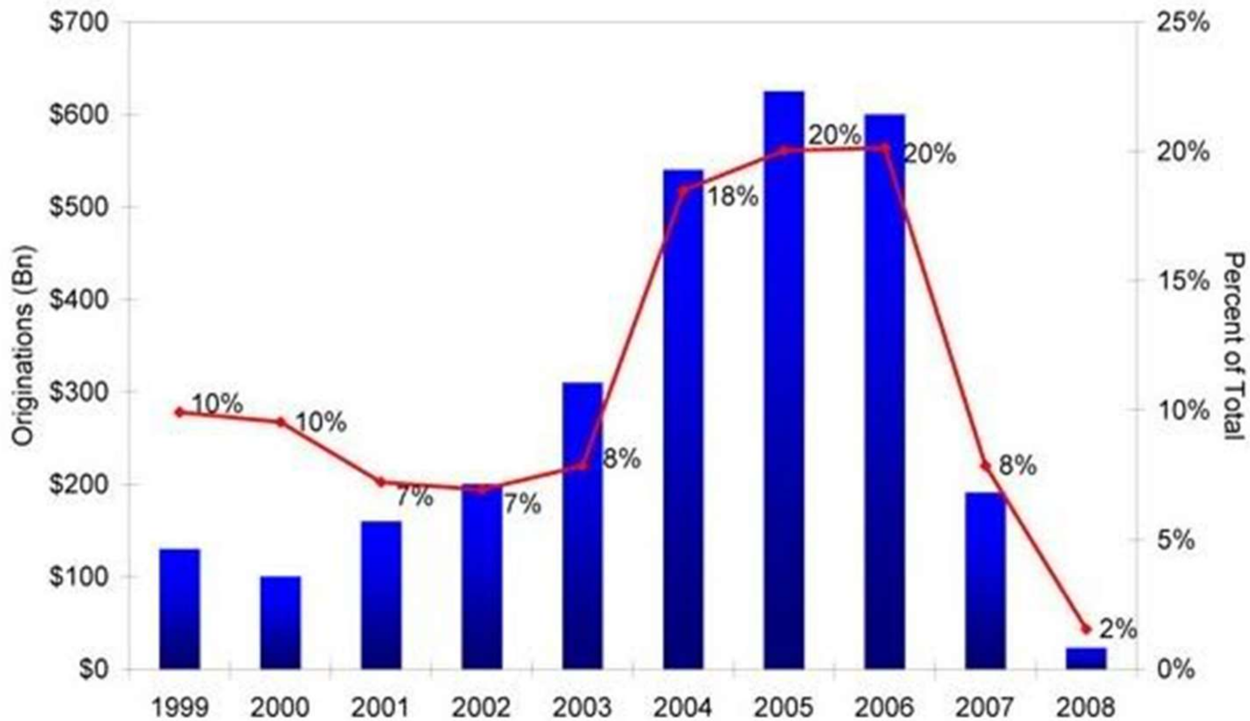
Latin American debt crisis and Brady Bonds

- US$160B in Brady Bonds were negotiated in the 1980s for countries in Africa, LA, and Asia. They were standardized and a secondary-market facility (through Citibank) made them liquid.
- By 1990 an 'emerging market' (EM) bond market emerged. In 1994, reaching US$1.7T in 1994 (of which Brady Bonds were 61%). The EM market peaked at US$6T in 1997 (East Asian/Russian crises), grew again to US$6.5T by 2008.
- The last Brady Bond issuance was in the 1990s.
- Secondary-market trading for EM/Brady debt is a form of financial market 'surveillance' over developing-economy policies.

From Brady Bonds to US subprime mortgage lending

- These new markets for risk opened the way for the financial inclusion of formerly excluded Black and Latino borrowers in US mortgage (and other) markets.
- In the 1990s, subprime mortgage loans were pioneered in US minority communities, with high penalty clauses, fees and rates.
- In the early 2000s, subprime mortgages supported a US housing-market bubble. Subprime mortgages were designed to fail unless housing prices rose. While only 20% of all mortgage debt, their failure as the housing bubble died brought down the advanced-economies' integrated financial system.

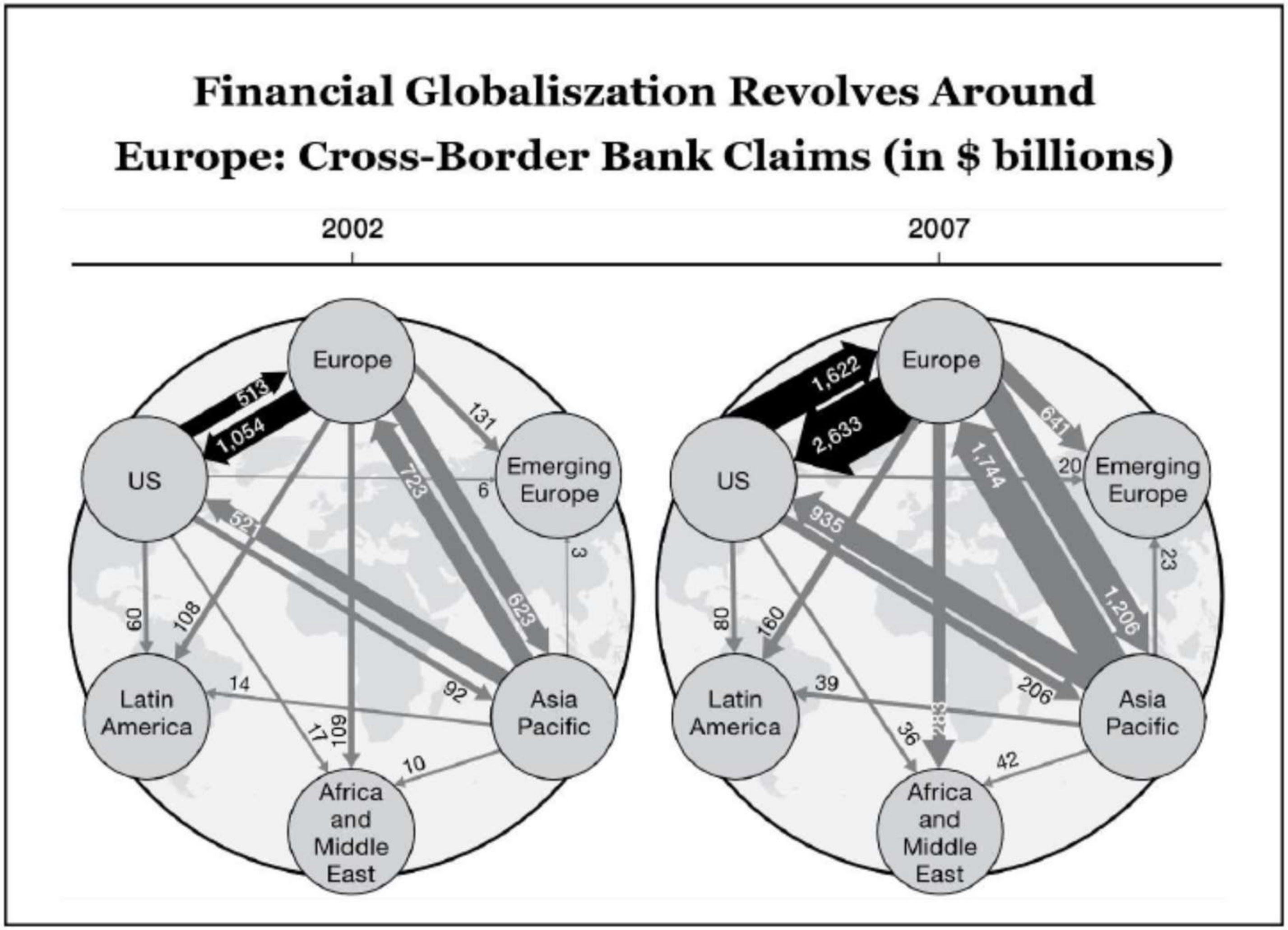
Figure 4.6 Subprime Mortgage Origination Volume



SOURCE: *Inside Mortgage Finance*, published by Inside Mortgage Finance Publications, Inc. Copyright 2009.

From Brady Bonds to US subprime mortgage lending

- Subprime contracts' structure was based on Brady Bonds (Lee Buchheit), and permitted their bundling into standardize, tradeable instruments.
- Like Brady Bonds, they created an extra upper tier of owners (hedge funds, pension funds, etc.) with a prior claim on cash flow. These owners were part of the integrated global financial market, which follows global conventions, not national law (except when it suits them (Argentina case).
- The Federal Reserve and US (and UK) Treasury bailed out the megabanks and shadow banks in 2008 at huge cost. Smaller banks were allowed to fail.
- No 'cramdown' of mortgages was possible because of the global power structure behind securitization. 12 million houses were foreclosed in the US, and all gains in wealth-building in the Black community were erased.
- UK public debt as a share of GDP doubled in one day in September 2008.



Adam Tooze, *Crashed: How a decade of financial crisis changed the world.* London: Allen Lane, 2018.

Beware the promised gains from securitization

- What promises portfolio diversification has permitted systemic risk that is resolved to the advantage of the financially empowered.
- The efficiency and scale offered by securitization creates new, upper-tier claimants on cash flows, who are 'first in line' regardless of national law.
- Leveraging developing-economy governments' lending capacity can lock in commitments that, if they come due, can asset-strip local wealth and generate austerity.
- What appears to be national control over financing can turn into a system driven by sophisticated global financial firms.

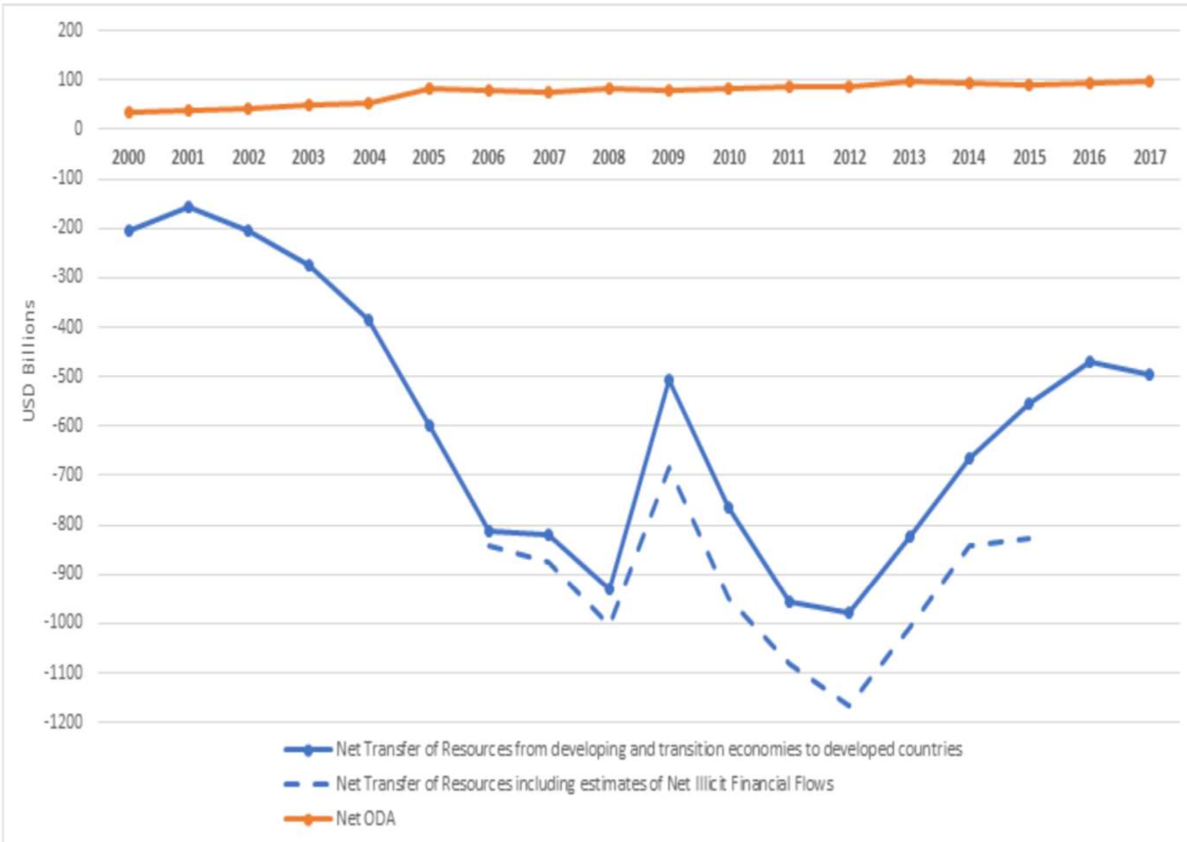
Securitization and shadow banking

- Entry into the global market does offer the prospect of leveraging local lending capacity and wealth.
- But insofar as the financial instruments created are sold into the global markets, they become part of a shadow-banking system whose many participants are seeking fees and above-market returns.
- The global financial system was systemically damaged in 2008 and has not regained the capacity to support small/medium firm financing. A rising proportion of its loans support financial position-taking.
- The entire system is backstopped by central banks' QE and provision of reserves to the hyperleveraged global money markets.
- The motivation of those controlling global finance has shifted from solving global problems to sustaining a crisis-prone system.

Securitization, debt, and developing economies

- Daniela Gabor has shown how blended lending through the African Development Bank has led to losses for local borrowers and to a net outward flow of wealth.
- The shadow-banking/securitization complex is always looking for new credit classes, and has generated more as-yet-uncontrolled risk since 2008 – the latest example is the leveraged-loan market, and education financing is now following.
- Climate change is creating new classes of 'stranded assets' – which involve financing commitments for which losses have to be taken.
- The global macro situation of developing countries is such that many blocs of these countries now have trade deficits and are net debtors, with rising debt problems. This is leading to slowing growth and triggering debt problems.

Figure 1. *Net resource transfers, net illicit financial flows from developing countries to developed countries and ODA flows, 2000-2017*



Source: UNCTAD secretariat calculations based on UNCTADstat, OECDStat, World Development indicators (WDI) and Global Financial Integrity (2019).[6]

To be sustainable, global finance must be transformed.

Why the megabanks must change:

1. The global system was only saved by a central bank using a currency with ‘exorbitant privilege’ whose value is now being squandered by an incautious US administration in power. Rescue will not be feasible again at this scale.
2. The polarization of wealth and income it has facilitated is destroying the very fabric of nation states. National governments can no longer provide for their people, and so people are on the move – remittances are now larger than ODA. The political reactions are killing democratic consent and fomenting extremist, anarchist, and even fascist movements.
3. The ‘stranding’ of assets cannot be predicted, and climate change will accelerate the volume of ‘stranded’ assets. Their costs cannot be pinned onto the weak and vulnerable.

What are banks for? What are shadow banks for?

- This is a systems problem, not a point problem.
- Since the 1980s there has been a fierce global competition to be at the top of the tree in the winner-takes-all game of global banking and finance. This game has been definitively won, for now by the US-based megabanks plugged into the Federal Reserve's backstopping of the leveraged global money markets. The European banks have competed and lost; the ECB will not, and cannot be the Fed. And the Fed is being undermined by current events.
- There is no alternative to the US-dollar-backed financial system now; but there has to be. So why not change? Why not remake European banking, in collaboration with developing economy banking, the financing vehicle that will underwrite the transition to global environmental and social sustainability?

The banking and financial system we need …

- We can't think from the perspective of 'how to work with the banking system we have, as it is; we have to ask, what banking and financial system do we need?'
- We don't need experts from the realms of global finance telling us we are not sophisticated enough to know what we need.
- We need transparent financial processes, and financial instruments – starting with blended finance – defined in such a way that they work for everyday people in everyday economies.
- We need to empower ourselves to ask, 'What do we need our financing system to do?'
- My answer? We need basic levels of support for human beings' prosperity and dignity across the world, via financing that is not subject to capture by corruption and self-aggrandisement for short-term benefit.

There is no going back to the old multilateralism. There is no single conductor. There are already many more orchestras in play. The world needs a new harmony.

From the G20 Eminent Persons Group, *Making the global financial system work for all.*

> "To bend the arc of history, we must succeed in Africa."

We can only agree.