Position PAPER

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Making Finance Work for the Greater Good

Finance is a key factor in economic growth and the pursuit of all other development objectives. Yet, financial markets have produced destructive crises and have contributed to rising inequality and unjust allocations of resources. Consequently, many efforts have focused on redesigning finance, redirecting resources toward serving sustainable and inclusive development, and improving the social control of finance. IDS has been at the forefront of research that critically explores these endeavours to make finance work better for development.

What do we know?

Several decades of deregulation and innovation have seen financial markets growing in scale and potency. This evolution has at times been evaluated more positively as *financial development* but also more critically as *financialisation*. Either way, low- and middle-income countries (LMICs) financial markets today are much more open, and hence more exposed, to global finance. Private foreign capital inflows to developing countries have been twice as high since 2010 as they were in the two decades before; while at the same time swings in global financial markets have, among other things, amplified food price volatility, hurting the poorest most. Financial shocks, ranging from currency crises in East Asia, the 2008 Global Financial Crisis, and a spate of microfinance crises (in India and other countries), have entailed setbacks to gains in socioeconomic development.

Thus, new modes of financing development and making finance serve the greater good are crucial to addressing capital shortages and pursue the wide ambitions of the Sustainable Development Goals (SDGs). These include social venture capital, impact investment and blended finance, but also revamped public financing through national development banks and new multilateral banks, as well as alternative community-based financing models.

With rapid innovation under way, questions of impact follow suit. For instance, there are many claims about the potential for venture capital investments in African small and medium enterprises (SMEs) to boost social impact, including through job creation, yet there is insufficient evidence to prove these impacts. Better metrics and methodologies are needed. Similar claims are made by impact investors (private investors investing for social and environmental returns alongside financial returns) and governments seeking to use *blended finance instruments* that lead private sector capital to more socially enhancing outcomes. In many LMICs, one key area of activity since the 2000s has been to increase financial inclusion, often via digital infrastructures, based on more than three decades of experience with microfinance. Worldwide, expanding access for all to financial services has been a growing concern among policymakers and regulators, yet vexing questions around the actual impacts and how to regulate in clients' best interests remain unresolved.

Governments have also reassessed how they engage with global financial markets, reasserting the state's role in directing finance toward politically-determined goals. By founding national as well as international development banks, such as the New Development Bank (NDB) or the Asian Infrastructure Investment Bank, they have leveraged more public and private capital for policy-directed investments and raised funds for South-South cooperation projects. These new policy directions reflect a growing recognition of how developing constraints under internationally agreed financial regulatory standards, such as the Basel Accords.

More radically, financiers, policymakers, activists and communities are also exploring alternatives to existing financing approaches. Raising capital for green transformations, scaling renewable energy investments, and averting climate change requires rethinking financing instruments and diagnostics. Green bonds and carbon finance markets present innovative opportunities, but their contribution to green transformations in emerging markets is still not fully clear. And even more ambitious projects are afoot to explore how social finance can balance economic development with social justice through participatory impact investing models that shift control and decision-making power from capital-rich investors to the investees, who are the intended beneficiaries.

How we work with others toward sustainable development

The research of the Business, Markets and the State cluster at IDS, often working with key stakeholders and leading global experts, is helping decision-makers to understand and respond to the wide-ranging lessons from ongoing financial innovations as well as episodes of financial overreach.

Our work in assessing the role of finance and evaluating SDGs such as no poverty (SDG 1), nutrition (SDG 2), decent work (SDG 8) and climate action (SDG 13) has impacted debates on the removal of restraints on finance has clarified that if finance is to serve development it is *time for a visible hand*. At a macro-financial level, financial regulation needs to dampen boom-bust cycles in financial markets, and public development banks should help finance structural transformation to more sustainable and inclusive economies.

At a micro level, we have also significantly contributed to building better knowledge about the potentials of different financing models. Recently, with 3ie, we were involved in completing the first-ever Systematic Review of Reviews in international development, which clarified the knowledge and knowledge gaps around economic, social, behavioural or gender empowerment-related effects of financial inclusion. We also work with investors and businesses including Aspen Network of Development Entrepreneurs (ANDE) and the Open Society Foundations, training investors and promoting practical guidance to make finance more inclusive, gender lensed, and participatory. Our findings have been presented at major events, such as SOCAP 2018. In our evaluation work with development finance institutions (Swedfund and CDC group), our research is leading to both changes in portfolio allocations to more poverty reducing sectors and learning on how to better mobilise private sector capital.

Institute of Development Studies

The Business, Markets and the State cluster investigates how businesses enable or constrain pathways that deliver development and curb inequalities, and how the relationships between business and the state influence these processes. Our interdisciplinary research builds on IDS' well-established track record working on value chains and market systems, complemented by political economy and participatory perspectives.

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Further reading

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Credits

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The Institute of Development Studies (IDS) is a global research and learning organisation for equitable and sustainable change.