COVID-19 and Blended Finance: Five Ways to Adaptively Respond

April 2020 • www.linclocal.org

Since the emergence of the novel coronavirus late last year, it has infected more than 2.6 million people, put nearly a third of the world's population on lockdown, and upended the global economy. Commonly referred to as COVID-19, the disease caused by the virus, its reach is global, and its health and economic consequences are currently affecting all of our societies. Capital is in full flight, particularly from developing countries, and one of the serious consequences of COVID-19 is that this capital departure will impede our ability to finance critical development projects in the years to come. While the development community's immediate focus is rightly on saving lives and preparing developing countries to deal with an expected wave of infections, learning to adapt to the changed investment landscape and harness increasingly limited resources for development will be critical to our ability to help finance the worldwide recovery.

Recognizing that traditional donors do not have the resources or expertise to single-handedly solve the world's development challenges, blended finance harnesses the power of the private sector to help finance development outcomes. Blended finance uses public and philanthropic resources to mobilize private capital to achieve development outcomes. Put more simply, it means using funds from a donor (like USAID) or a philanthropic source (like a foundation) to attract funds from a private sector investor and using these "blended" funds to help solve a development problem. By "crowding in" private sector funds that would not otherwise have been devoted to a development problem, blended finance can mobilize more financial resources to solve development challenges.

Source: OECD

Much is still unknown about how COVID-19 will influence long term development goals but in interviewing a variety of blended finance actors recently, we identified COVID-19's primary challenges and five ways donors can adaptively respond to the crisis.

Rapid Damage, Long Lasting Impact: Private sector dollars are going to be scarce, at least in the short run, creating new challenges for crowding in resources. In addition to the enormous loss of life and immediate economic damage being inflicted worldwide, the economic "tail" from COVID-19 will last for years. The effects will be particularly severe in the frontier and emerging countries in which we work because those countries have innumerable infrastructure, healthcare, and resource challenges that will complicate their COVID recoveries.

Oxfam has recently reported that six to eight percent of the global population could be forced into poverty due to COVID-19 and anti-poverty efforts could be set back by a decade, and up to 30 years in some regions. Over half the global population could be living in poverty as a result of COVID-19. Further, years of donor progress promoting economic growth, supporting entrepreneurs and small and medium business, and fostering job growth could be wiped away.

According to the IMF, "Investors have already removed US$83 billion from emerging markets since the beginning of the crisis, the largest capital outflow ever recorded." Written in March, that number is probably orders of magnitude higher now. And UNCTAD estimates that global foreign direct investment (FDI) could potentially shrink by 40 percent. This should be unsurprising given the volatility of private sector flows; for instance, during the last recession, the OECD estimates that flows dropped precipitously from just over $300 billion to $100 billion between just 2007 and 2008. Domestic resource mobilization will presumably be similarly affected. This means that COVID-19 will leave a trail of damage in developing countries that have fewer resources than before to address them.

"Traditional timelines and business processes are no longer acceptable. The needs are immense, and urgent."

USAID also notes that there has been a reduction in demand for energy and commodities across the world, which were some of the primary sectors for blended finance transactions. Commodity exports likewise represent huge portions of many countries' economies, and "[T]he decrease in demand for the commodities… is poised to shake the economic foundation of much of the developing world." Both the public and private sectors need to prepare for this reality.

Donor Response: As donors seek to respond to the increasing development needs while addressing the current private sector context, here are five key areas for consideration in light of COVID-19.

1. **Invest in Understanding Risk**: Investors undertake an elaborate risk/return analysis when considering potential investment opportunities and donors should consider how investors are viewing the changed landscape. Matthew Meredith, managing principal of investment advisory firm LixCap, shared that "Investing in the US right now is a safe bet, since the market is low. It will rebound, and people know they can make money. The situation in emerging markets will be different though and this may scare off some investors, particularly new entrants or others who were on the fence and thinking about getting in. This will very much affect the availability of capital for the next several years." At the same time, Thomas Flahive, a partner at CrossBoundary, reports that many of their investors are continuing the projects that were already in the works, and some are looking for new, distressed, opportunities, a sign that not all investors have been dissuaded.

   Due diligence is a critical stage in any deal and it could become even more complicated than before. How will travel restrictions affect the ability for investors to do due diligence? Will investors be comfortable with remote/virtual reviews in lieu of physical site visits? Can the donor community leverage the capabilities and tools they have developed doing remote monitoring of aid delivery in conflict or other non-permissive environments (third-party monitoring, GIS-tagged images, etc) and share them with the private sector investment community?

2. **Identify Emergent Opportunities**: Catharina Dyvik and Katherine Stodulka of the Blended Finance Taskforce note the growing conversations about the opportunity to focus on rebuilding better, stronger, more sustainable, and more resilient systems in the future. For instance, could donors harness the lessons learned from this challenging time to channel current and future investment to rebuild systems (energy, water, etc.) that are better able to withstand shocks (like future pandemics or climate change)?

   Similarly, there are growing calls from countries around the world to produce test kits, medicines, and personal protective equipment (PPE) domestically, to be less reliant on foreign sources for these vital supplies. Could this provide blended finance opportunities to help build up that pharmaceutical and manufacturing base?

3. **Improve Timing:** Blended finance deals have historically been complicated and time-consuming affairs, but traditional timelines and business processes are no longer acceptable. The needs are immense, and urgent. As Convergence has noted, donors should "Scale up quickly and recycle what works." Dalberg echoes this sentiment by arguing that DFIs (development finance institutions) should "expedite deal processing times. The next two years will not be business as usual for most DFIs." While commendable, it remains to be seen how realistic these recommendations are. Large public agencies do not have a reputation of being the nimblest organizations, and investors will still require due diligence for their projects. Further, the travel restrictions and other shocks may likely complicate the relationship-building and resource mobilization that are key to successful transactions. At the same time, donors will face enormous pressure to respond quickly, to repair the damage and support reconstruction. Perhaps this imperative will spur innovation and dramatic process change.

4. **Build Internal Capacities**: Many donors have been working hard to build their internal capacities to design and deploy blended finance approaches, including efforts to build the evidence base of what works and strengthen the capacities of their staff. These efforts should be bolstered, so that staff across diverse technical sectors (health, food security, environmental protection, etc.) understand the benefits of blended finance approaches, know how to use them, and have the organizational support to be successful.

5. **Support Preparedness and Response Investments**: Donors have a development mandate and social and economic development is therefore integral to their work. But the private sector does not have a development mandate. It is essential that as donors seek to move forward with blended finance transactions and mobilize private capital for development in these extraordinary times, they consider smart, systemic incentives to encourage investment in developing countries.

   For example, businesses do not have an incentive to invest in unused (and non-profitable) capacity, be it surplus hospital beds, product, or equipment. Governments, on the other hand, have an incentive to ensure those capacities exist or that surge capacity can be rapidly deployed. Governments and donors must therefore support incentives for the private sector to not only proactively engage in blended finance deals now, but also contribute toward long-term resiliency planning. Perhaps some preferential tax treatment for such resiliency investments? With many government offering finance assistance packages to business, can financial assistance be tied to wellbeing/development outcomes?

Closing thoughts

Blended finance was a burgeoning space prior to the COVID-19 pandemic and seems to warrant even more attention now, given that the scale of the needs in the years to come - across technical sectors and countries - far surpasses what traditional donors can provide. Expertise, innovation, and funding will be more important than ever, and it is therefore even more critical that donors partner with the private sector. As Naveen Rao of the Rockefeller Foundation has noted, “The private sector can't tackle COVID by itself, and neither can the public or NGO sectors. We all need to come together.”

We now face innumerable new (and unknown) challenges in blended finance. Will we be able to overcome them? Blended finance is used when the private sector deems the investment risk too great, or the potential returns too meager, to justify investing. It is an approach to be used – ideally – temporarily, until the markets develop. But that ideal state will have likely moved further into the future in many countries. For many now, priority has become sustaining what exists and avoiding walking back recent development gains.

There are still many open questions for those in this space, such as:

How will donors entice and engage the private sector? Will the space be occupied only by existing investors, or is it possible to entice new investors? Where do the interests align? What are the best incentives and structures to use to achieve both development impact and a financial return for the private sector? What are the best ways for donors to build an organizational infrastructure to rapidly design and deploy blended finance? How do donors, governments, investors, and development actors most effectively adapt current programs to address COVID-19 and its impact and design new ones for the future?

This article was written by LINC, a US-based organization that assists local and international organizations to effectively design projects, increase institutional capacity, forge lasting partnerships, and measure impact. LINC is the implementer of the USAID CAPx (Capital Impact Exchange) Activity, which is designed to advance the knowledge base, generate and analyze evidence, and adaptively inform USAID’s efforts to catalyze private investment for development outcomes.