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# Chief Economist of International Development Agencies & Financial Institutions

## Background paper theme 1 - Shifts in economic and financial systems and architecture

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This document contains the Issue paper on theme 1 – Shifts in economic and financial systems and architecture of the informal meeting of Chief Economists of International Development Agencies & Finance Institutions, which took place on 5 and 6 October 2023.

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# Shifts in economic and financial systems and architecture

Background paper for discussion

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## Session overview

*As more low- and middle-income countries struggle with fiscal space, adapt to changes and uncertainty in the wider financing environment, and mobilise investments in sustainable development, the session will focus on the drivers, nature, opportunities and risks of shifts in economic and financial systems, and architecture at national and international levels. It will explore how evolving reform of the international finance system responds to pressing issues including criticisms on its structure, climate change, rising debt distress, high interest rates and inflation, and is conducive to rethinking financial instruments and country capacity to raise long-term finance.*

*The session will address strategic opportunities for low- and middle-income countries in current reform efforts and explore their limitations. Participants will discuss enabling environments, real and perceived risks for official and private creditors, financing costs and the effects of sovereign ratings, as well as the latest evidence and thinking on the role, comparative advantages and effectiveness of multilateral, bilateral and domestic financing instruments in the current environment with a view to identifying common ground on next steps.*

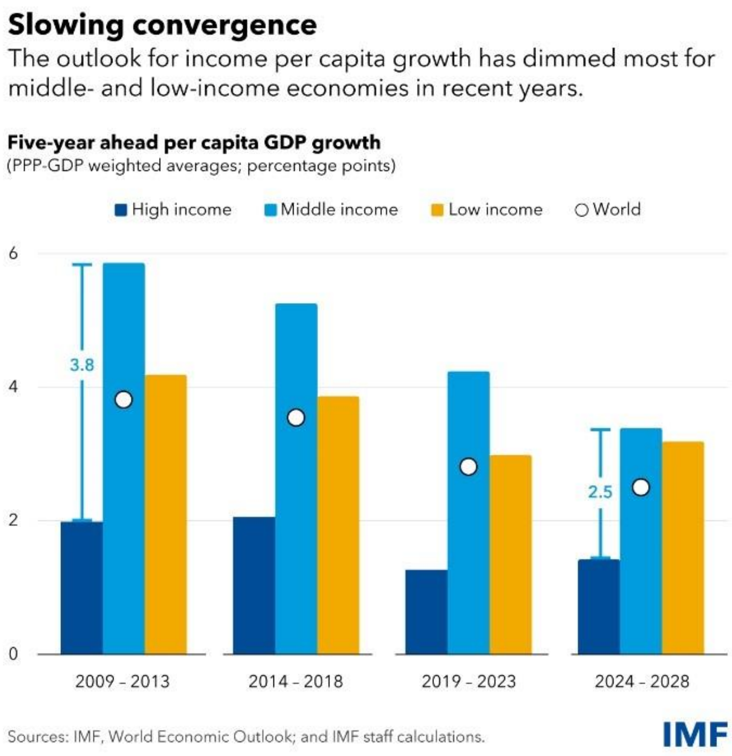
## Current economic and finance trends

Economic outlook for low- and middle-income countries is variable, but access to affordable finance, including concessional loans and grants and debt relief to free up fiscal space, is challenging for all
The annual investment gap to meet the SDGs currently stands at USD 4 trillion, up from USD 2.5 trillion in 2014 (UNCTAD). As the needs grow, access to affordable finance for low- and middle-income countries has been impacted by the economic repercussions of subsequent shocks of the the COVID-19 crisis and Russia's war of aggression against Ukraine. While vulnerabilities differ across countries and regions, exposure, and sources of resilience, after an era of low interest rates, strong growth and relative geopolitical stability, many countries now find themselves in new terrain and with few financing options.

Global growth is projected to fall in 2023 and 2024 to around 3 percent (IMF & OECD). Beneath this global picture is considerable heterogeneity. The outlook for developing Asia, for example, is more optimistic and projected to grow by 4.7% in 2023 and 4.8% in 2024 (ADB). Africa's growth rate, though it has been impacted by external shocks, is expected to stabilise at 4.1% in 2023-24 (AfDB) while Latin America and the Caribbean is expected to grow just 1% in 2023 (IADB). Even for regions where growth is stronger than the global average, potential threats are raising concern including impacts on exports in Africa, and possible ripple effects of a slowdown in China's housing sector for the rest of Asia. In the medium-term,

[1] With input from Olivier Cattaneo, OECD & Eleanor Carey, OECD

the outlook for GDP per capita growth across low- and middle-income economies is falling, leading to slowing convergence.

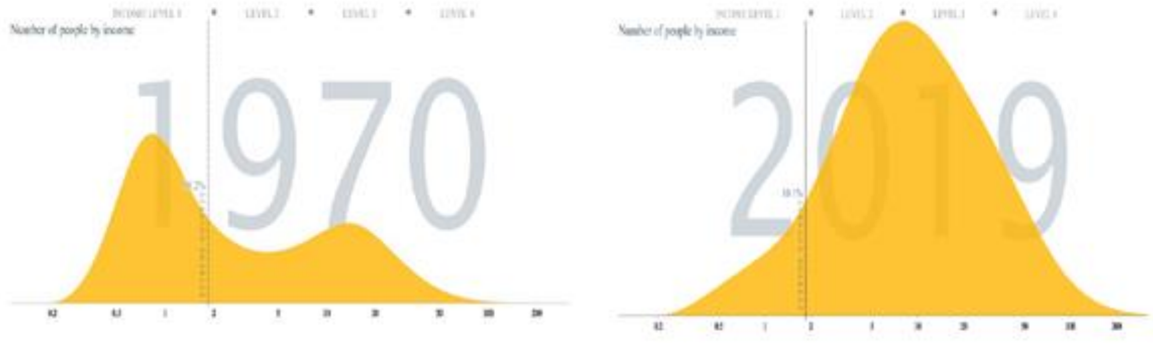



The rising cost of capital as a response to inflation, the US Federal Researve raised rates 11 times between March 2022 and July 2023 while the European Central Bank raised rates 10 times from July 2022 to September 2023, has made both debt repayments and raising of new financing more difficult. For sub-Saharan Africa for example, this external environment coupled with rising inflation at home has been described as a big funding squeeze.

Global foreign direct investment (FDI) has also fallen and while a few large emerging economies did attract investment in 2022, flows to least developed countries declined (Africa's FDI was down 44% year-on-year in 2022). Official development assistance (ODA), though rising to historic highs year-on-year since 2020 to reach USD 204 billion in 2022, is under immense pressure and can offer only limited support to countries whose needs far outstrip ODA supply.

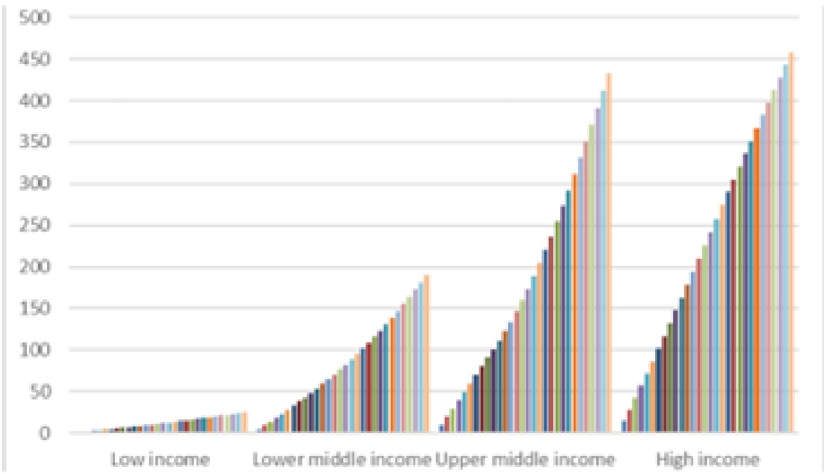
## Addressing short- and long-term needs of low- and middle-income countries in international financing architecture (IFA) reform

As early as 2010 G20 leaders have been signaling the need for IFA reform (G20 Seoul Summit, Framework for Strong Sustainable and Balanced Growth, 2018 Buenos Aires Summit which presented the final report of the International Financial Architecture Working Group). Impetus for reform was drawn from the 2008-09 global financial crisis, the need to accommodate rising development and climate finance needs solidified around the SDGs and Paris Agenda. More recently, questions have been raised about country classifications and resulting eligibility for concessional finance, and whether income-grouping remains the most pertinent indicator of vulnerability (see the dramatic change in the distribution of wealth between 1970 and 2019).




Source: Gapminder. Income Mountains | Gapminder

Further complicating questions of access to finance is the rise of middle-income countries as significant Greenhouse Gas emitters (see below) and therefore in need of support to achieve global climate goals.




Source: WDI

The COVID-19 crisis significantly accelerated the movement for reform. 2021 saw G7 leaders commit to various measures including enhanced multilateral finance, followed in 2022 by the launch of the Bridgetown Agenda by Barbados, calling for urgent action on debt vulnerability, access to concessional financing, and addressing climate and health emergencies. In the same year, an Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks urged MDBs to make more efficient use of their capital. The 2023 Summit for a New Global Financing Pact set out a roadmap up to the Summit of the Future in 2024.

Navigating architecture reforms that will be deliberated and decided on by large membership institutions, as well as reacting to the wider reverberations of market changes is a daunting task for all low- and middle-income countries. Maximising developmental outcomes within this process will require careful consideration of the opportunities and limitations as well as the very different needs and capacities of countries to engage in the process. The following sections outline key areas of the reform process that are particularly important to address short- and long-term needs.

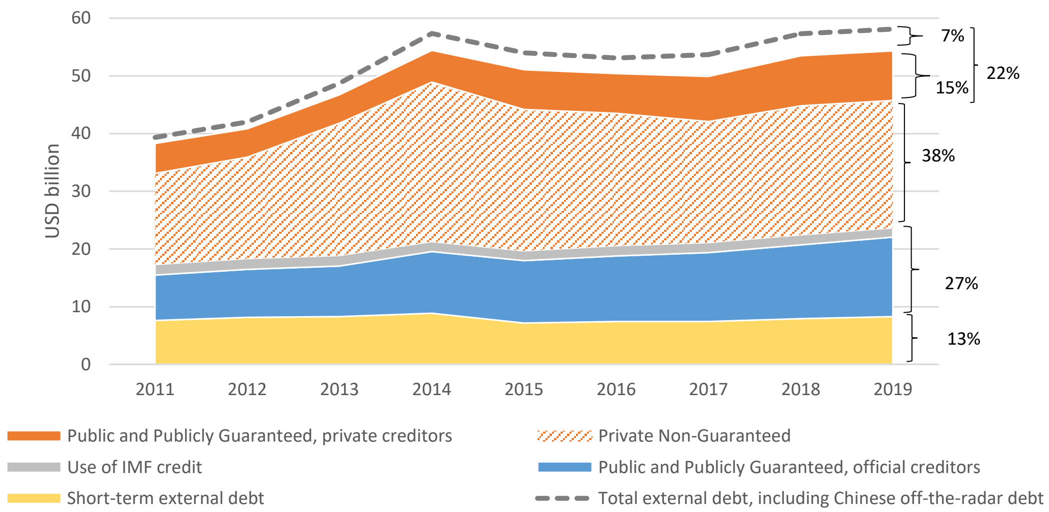
### (1) Dealing with debt

While debt in low-income countries is not currently at the levels seen before the introduction of the Highly Indebted Poor Countries Initiative, debt composition has changed significantly with concessional debt now playing a much smaller role than in the early 1990s and domestic, private and Chinese debt being much more prominent. This more heterogenous landscape has made co-ordinated action on debt difficult and slow. Many low- and middle-income countries are now experiencing or are at risk of debt distress, high inflation and depreciation of their currencies against a strong dollar, loss of access to market finance, and the prospect of re-financing large proportions of their marketable debt at higher interest rates in the coming years.

Research informing new approaches to debt sustainability will have an important role within the architecture reform due to the increasing diversity and complexity of actors and instruments, and rising levels of debt. A number of solutions have been advanced in the reform process to restore some fiscal space through debt treatment in developing countries, including in the case of climate shocks or in support of investment in climate and biodiversity. Some solutions have already been pioneered, e.g. debt for nature swaps and climate-related debt clauses are being pursued. There is, however, still little analysis of the optimal design and efficiency of these instruments and their potential collateral effects. How will the use of those instruments be interpreted by credit rating agencies? How to ensure a sustainable use of fiscal space and investment in SDGs to create a higher return and not add to the debt problem?

**When incorporating off-the-radar Chinese debt, SIDS' private guaranteed-like debt mays increase by almost fifty per cent**

USD billion, current prices




Source: OECD

The debt issue is highly political due to emergence of new lenders. China is now the largest bilateral lender to developing countries, outstripping all Paris Club bilateral lenders combined. Recent analysis found that 22 debtor countries received USD 240 billion in Chinese rescue lending (Central Bank Swap Lines and rescue loans) since 2000. The majority of this assistance was made available in recent years, aligning with China's rise as an important creditor, and to low- and middle-income countries already heavily indebted to China – essentially preventing default on Chinese debt already extended. This represents a significant challenge for the members of the Paris Club, since the coordination of all sovereign creditors becomes structurally more complex and restructuring deals harder to reach.

(2) **Mobilising additional finance**

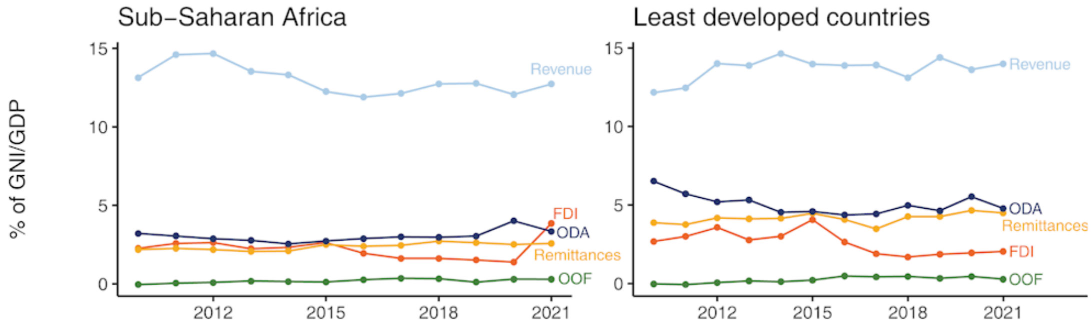
Concessional finance is increasingly called upon to leverage more resources for development goals. In 2020, mobilisation of private finance for development reached USD 50.77 billion, predominantly benefitting middle-income countries in Africa and Asia and was concentrated in economic infrastructure and services. Respondents to a recent OECD survey signalled intention to scale up mobilisation. In addition, ODA could be more efficiently used as a lever or catalyst to mobilise other sources of financing and increase their development impact. But mobilisation has not yet succeeded in unlocking the necessary trillions to close the development financing gap, and much more needs to be done to encourage investment into sectors and countries that would not otherwise benefit.

A number of innovative financing instruments have been tried or are being developed, which could potentially have an impact on mobilisation and allocation of resources across countries or sectors. However, much more research and evidence is required to understand their benefits, impacts and long-term effects for different contexts. For example:

- Green Social Sustainability and Sustainability-linked bonds: beyond the "flavor of the month" effect of all kinds of sustainability bonds, in countries where saving is traditionally low, are sustainability bonds likely to create a new enthusiasm for bonds?
- Blended finance: the use of blended finance in low-income countries is limited. What are the conditions for successful risk-sharing?
- New issuance and transfer of IMF Special Drawing Rights: how to make the most of SDR reallocations throughout the financial architecture of Development Banks?
- "Sweating the balance sheet of MDBs": what would be the consequences of a lower public to private finance ratio in MDBs' balance sheet in terms of conditions, objectives and accessibility?
- Just energy transition partnerships: what are the lessons from those new approaches that triggered lots of attention in the G20 and other forums?

Actors such as national and regional public development banks are also starting to play increasingly important roles in mobilisation and investment.

In addition to raising the levels of private and international public finance available for development, countries can also take steps to mobilise domestic resources. As a proportion of GDP, domestic revenue is the single largest source of financing for both sub-Saharan Africa and least developed countries, by a wide margin (see figure).




Source: OECD

Concessional resources can support domestic revenue mobilisation in low- and middle-income countries through technical assistance for public financial management reform, strengthening tax systems, tackling illicit financial flows and other targeted support. ODA to domestic revenue mobilisation has increased in recent years and the role of multilaterals has also strengthened. However, ODA to DRM is highly concentrated, benefitting just a few countries.

### (3) Inclusive, geopolitically aware governance of emerging architecture

Technical changes proposed as part of the global financing architecture reform have important geopolitical consequences. For example, a capital increase of MDBs could lead to a renegotiation of voting shares. A stronger voice in decision-making for low- and middle-income countries is a strong driver for reform of international institutions. The recent BRICS Summit which admitted 6 new members (Saudi Arabia, Iran, Ethiopia, Egypt, Argentina, UAE) and received applications from many more countries can be interpreted as a sign of multipolarity. Governance mechanisms of the emerging architecture will need to strike the right balance between being inclusive as well as aware of the changing geopolitical reality. Co-ordination mechanisms at each layer, e.g. between bilateral agencies, between the 200+ multilateral institutions that are active in development cooperation, but also across the layers, for instance between national and multilateral public development banks, will be critical to improve coherence and avoid geopolitical capture.

## Discussion questions for breakout groups

For each question, groups should consider regional variations, financing options for countries of various income levels and those with or without market access, and other sources of vulnerability, e.g. climate vulnerability:

- What are the greatest opportunities and challenges for low- and middle-income countries in the current international architecture reform process? How can multilateral, bilateral and non state international development actors best maximise the opportunities? What are the incentives to step-up action and what is the fastest possible timeline for action?
- What are promising avenues to address debt and support developmental spending, taking the composition of debt into account?

- As the development and climate finance gaps continue to grow, what could be the catalyst(s) for the mobilisation of additional private, international public or domestic finance for low- and middle-income countries to take the necessary leap forward? How do we balance excitement about new instruments with the ongoing, longterm need for structural reform?
- How can governance of emerging architecture strike a balance between geopolitical pressures and inclusiveness?