T20 Policy Brief

Task Force 5
Purpose & Performance: Reassessing the Global Financial Order

A LONG-TERM DEVELOPMENT INVESTMENT FRAMEWORK FOR LMICs

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Abstract

Low- and lower-middle-income countries (LMICs) are home to 50 percent of global population but have only 10.4 percent of the world's investment (capital formation). Indeed, for these developing countries, the financing gap for achieving the Sustainable Development Goals (SDGs) will amount to US$4.2 trillion annually until 2030 (OECD, 2020). To help close this gap, this Policy Brief proposes that the G20: 1) Review the existing development financing scheme; 2) Develop domestic credit markets in LMICs; 3) Reform the private capital market credit rating system; 4) Restructure existing official debts for long-term low-interest finance; 5) Integrate blended financing in development financing schemes involving philanthropies and private companies; 6) Create a coordination and cooperation body involving global, regional and national development financial institutions; and 7) Establish national-level development banks.

The Challenge

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The task of achieving the Sustainable Development Goals (SDGs) by 2030 has become only more difficult in the aftermath of the Covid-19 pandemic. Prior to the pandemic, progress in achieving the SDGs was already falling short, and today the financing gap remains substantial. The annual SDGs financing gap before Covid-19 amounted to US$2.5 trillion (OECD, 2020). This gap is attributed to low-income countries for US$500 billion and other developing countries for US$2 trillion; these figures translate to additional annual spending of 15 percent and 4 percent of GDP, respectively (Gaspar et al., 2019). Yet, governments' budget capacity is highly constrained. Revenue from taxes in roughly a third of developing nations (46) was less than 15 percent of GDP, and in approximately two-thirds (79) of ODA-eligible countries, it was less than 20 percent (OECD, 2020)—these amounts are lower than the thresholds generally considered to be necessary for a state to function effectively.

Such a condition was exacerbated by the Covid-19 pandemic. Due to the economic shocks, muted economic activity, and a sizable decline in state revenue, many developing countries had a significant increase of pressure in their SDGs financing levels due to rising public debt and debt servicing costs. Furthermore, several developing countries also confronted the economic downturn with smaller fiscal buffers than during the 2008-09 crisis. In 2019, half of the 69 countries using the low-income countries' debt sustainability analysis were either "in debt distress" or "at high risk of debt distress," compared to 23 percent in 2013 (IMF, 2020).

Government debt had risen due to expectations of rapid growth, particularly in low-income countries, where it had risen by 20 percentage points on average following large declines in the 2000s following the HIPC initiative. Non-financial corporate debt also ballooned in emerging markets, from US$ 1.6 to US$ 3.8 trillion between 2009 and 2019, leading to vulnerabilities and "sudden stops" in international credit (Avdjiev, McGuire and von Peter, 2020). This translates to the need for aggregate investment and development spending to an incremental US$1.3 trillion by 2025 and US$3.5 trillion by 2030 (Bhattacharya et al., 2022).

Raising funds on this scale necessitates global collaboration, particularly in light of the Addis Ababa Action Agenda's commitment to "seek to align financing flows and policies with economic, social, and environmental priorities" (United Nations 2015). Unfortunately, despite the pledged commitment, there remains a significant funding gap for the SDGs.

When it comes to the development agenda in LMICs, the discrepancy between estimated figures and implementation is much more pronounced. Despite their commitment to the SDGs, many of these nations are frequently constrained by limited fiscal flexibility and binding external financing constraints. Even before Covid-19, large-scale attempts in lower- and middle-income nations to pursue at least one development priority, such as decarbonisation, frequently entailed abandoning other development budgetary items critical to long-term economic advancement, such as roads, schools, and hospitals. Covid-19 worsened fiscal restrictions for LMICs, forcing them to prioritise short-term economic recovery associated with consumption above long-term investment demands.

In addition, their domestic financial markets are not sufficiently deep to raise enough finance for a full-scale sustainable development effort in the face of ongoing revenue shortfalls. A relatively shallow domestic financial market means that bond issuance, even in local currency, will have to be partially absorbed by international investors. This poses a vulnerability issue for both exchange rate and government bond yield in the medium term. A present rise in global interest rates may result in enormous capital outflows. Financing through the issuance of bonds in hard currencies also carries medium-term risks, as hedging in developing countries' currencies tends to be expensive, and unhedged bond issuance may expose developing countries' borrowers to a highly unsustainable fiscal position if global interest rates rise and their currencies depreciate at the same time. Thus, tapping into the much-needed international pool of funds to close the SDGs financing gap comes with difficulties and high costs.

Leaving LMICs shouldering the full cost of pursuing SDGs is not only unfeasible, given their fiscal constraints, but also unfair as realising SDGs will bring common benefits to every country collectively. Still, the economic costs are asymmetrical and skewed towards developing countries on relative terms. LMICs, in general, face a higher cost of capital (both financial and economic). Allocating resources that can be used for other long-term economic development needs means that the opportunity costs for sustainable development in developing countries are also higher than in developed countries. Mobilising funds from developed countries into developing for sustainable development at a low cost is therefore critical to achieving the common goal of SDGs on a global level.

At the same time, the unprecedented budget deficit caused by the ongoing recovery efforts from the Covid-19 outbreak has put further strains on the fiscal circumstances of many industrialised countries, preventing large-scale intergovernmental transfers in the short- to medium-run. Because of the relatively little fiscal room available as a result of the rising debt-to-GDP ratio and existing domestic political constraints, the feasible amount that can be allocated through traditional financing instruments, such as government-to-government soft loans and/or direct aid, will fall short of the amount required to assist developing countries in their efforts meaningfully. Alternative low-cost funding sources for sustainable development projects in underdeveloped nations are urgently needed to fill the gap.

The G20's Role

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Role 1: Long-term development investment framework must involve international financial institutions.

Creating a robust long-term development investment framework requires the involvement of international financial institutions, such as the Bretton Woods institutions. With a substantial country membership—190 countries for the International Monetary Fund (IMF) and 189 countries for the World Bank—these institutions possess the necessary influence to establish such a framework.

The IMF plays a crucial role in promoting global macroeconomic and financial stability. It provides policy advice and capacity development support to assist countries in building and maintaining strong economies. Additionally, the IMF offers short- and medium-term loans to countries facing balance of payments problems and difficulties in meeting international payment obligations. This support enables countries to address short-term challenges and create a conducive environment for long-term development investment.

Meanwhile, the World Bank is mandated to promote long-term economic development and poverty alleviation. It provides technical and financial assistance to countries in order to help them implement reforms or initiatives targeted at attaining long-term economic growth as well as poverty reduction. The World Bank's expertise and resources contribute to the design and implementation of development projects that are critical to long-term investment in key areas such as infrastructure, education, healthcare, and agriculture.

Role 2: Importance of private financial flows

The shifting landscape of international development finance has witnessed the increasing importance of private financial flows, surpassing traditional ODA and other public flows. Developing countries must effectively harness private financial flows for long-term investment while maintaining macroeconomic stability. In this context, the G20 could play a significant role in discussing and exploring possibilities, as it includes countries with major private investors. Despite past failures in implementing Public-Private Partnerships (PPP) for infrastructure development, it is crucial not to abandon the utilisation of private funds. Rather, there is a need to focus on designing and implementing well-structured projects that attract private investment. This entails improving the investment climate and enhancing the efficacy of the governmental sector in developing countries. The G20 can call for constructive cooperation between the North and the South to foster successful PPP models. Furthermore, the G20 can also encourage developing countries to establish healthy domestic financial resource circulation, which includes promoting domestic saving, domestic investment, tax collection, and public investment. Such efforts can build sustainable and self-reliant economies in developing countries, leading to long-term development outcomes.

Role 3: G20's role as the biggest multilateral forum

The increasing investment towards middle- and low-income countries transcends national boundaries, and addressing this issue necessitates collaboration and coordination beyond the national level. In this context, the G20, as the largest multilateral forum, plays a pivotal role. Currently, the G20 represents the 20 biggest economies in the world, accounting for 80 percent of global GDP, 75 percent of international trade, and two-thirds of the global population. As such, the G20 has a unique platform for discussing and addressing the challenges and opportunities associated with investment in developing countries.

Furthermore, developing countries that are members of the G20 have a moral obligation to represent and voice the needs of other developing countries that are not part of the G20. By leveraging the G20 platform, developing countries can advocate for policies, initiatives, and resources that promote inclusive and sustainable development, particularly for developing countries facing financial constraints. The G20 can foster cooperation, coordination, and mutual support among member countries and beyond to facilitate investment and development outcomes in middle- and low-income countries at a global scale.

Recommendations to the G20

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In accordance with the challenges mentioned above, we outline the following policy recommendations:

Recommendation 1: A review of the existing development financing scheme by Multilateral Development Banks (MDBs)

There is a need to review the existing development financing scheme to ensure its effectiveness and relevance in today's rapidly changing global landscape. As economic, social, and environmental challenges continue to evolve, it is imperative for development financing schemes to keep pace with these changes. By conducting a comprehensive review, policymakers and institutions can better understand the strengths and weaknesses of the current system, and identify areas that require improvement.

Recommendation 2: Development of domestic credit markets in LMICs

Shallow and underdeveloped credit markets in LMICs often result in inefficiencies in investment allocation, as funds may not be channeled to their most productive uses. However, the development of domestic credit markets has the potential to boost the productivity of loanable funds. When robust and well-functioning, credit markets can provide a reliable and efficient means for businesses and individuals to access financing for investment in productive activities, such as infrastructure development, entrepreneurship, and human capital formation. This, in turn, can stimulate economic growth and create employment opportunities, contributing to poverty reduction and improved standards of living. Furthermore, the development of domestic credit markets can help mobilise domestic savings, reduce reliance on external financing, and provide a stable and sustainable source of funding for long-term investment projects. The G20 could take the leadership role to provide technical assistance and develop a framework to boost the development of the domestic credit market in LMICs. The G20 leaders could also invite the MDBs to participate in this scheme.

Recommendation 3: Reform of the private capital market credit rating system

The difficulties faced by the poorer nations in accessing development financing have highlighted the need for reforms in the credit rating system. The objective of such reforms is to improve the assessment by incorporating criteria related to the SDGs. Including the SDG criteria in credit rating assessments will enhance the creditworthiness of countries that are dedicated to pursuing their development agendas. This could lead to improved access to more affordable financing, subject to conditionality based on progress in the development agenda. A better credit rating could enable countries to attract more favourable financing terms and conditions, which in turn could facilitate their efforts towards sustainable development.

As many financial institutions have attempted to include sustainability scoring towards their credit assessment, this could be normalised further by including SDGs criteria within the credit rating assessment. G20 countries could take a leadership role in facilitating the discussion with private sectors and rating agencies such that credit rating assessment will better reflect the progress on the SDGs criteria.

Recommendation 4: Restructuring existing official debts for long-term, low-interest finance

As LMICs continue to deal with the fallout from the pandemic, outstanding loans limit not just their fiscal room to respond quickly to the crisis but also their future development. Many LMICs, particularly those with lower income levels and shallow domestic capital markets that are already struggling to service existing debt, have required immediate and massive financing, only to discover that it is too expensive or difficult to borrow in sufficient amounts to facilitate economic recovery following the pandemic. Even if they continue to have access to the capital market, the new debt burden will impede them for years to come, for example, by lowering their credit ratings and increasing the cost of borrowing, decreasing their prospects for long-term economic development.

One historical challenge has been the limited participation of private creditors in debt restructuring initiatives. This is due, in part, to the lack of financial incentives for private creditors to accept below-market interest rates, as evidenced in the case of the Debt Service Suspension Initiative (DSSI). Another challenge is the absence of unified private creditor committees, which makes it difficult to achieve a unified perspective, as seen in the recent case of Argentina (White & Case, 2021). Recent research suggests that private creditors may wield a de facto preferred creditor status among sovereign borrowers (White & Case, 2021). These factors highlight the need for reforms in the debt sustainability framework to address the challenges associated with private creditor participation in debt restructuring efforts. This may include exploring mechanisms to align financial incentives for private creditors to participate in debt restructuring, enhancing coordination and cooperation among private creditors, and ensuring a level playing field among different classes of creditors.

In response to this situation, a Debt Service Suspension Initiative (DSSI) has been established by the G20, allowing LMICs to suspend official bilateral debt service payments. The measures taken by the international community to date have not sufficiently addressed the worsening debt sustainability problem. The DSSI, which ended in December 2021, provided a mere US$13 billion in temporary relief to 48 low-income countries through suspension of debt-service payments owed to their official bilateral creditors (G20, 2022). However, private creditors, as the holders of the biggest share of developing countries' debt, did not participate in this initiative. To follow up on this initiative, the G20 has put forward a Common Framework for debt treatment beyond the DSSI to address the insolvency and protracted liquidity problems. Regardless, it has its shortcomings in the form of excluding middle-income countries and lacking a mechanism for meaningful private creditor involvement. Consequentially, only three countries have taken part in the Common Framework. In each case, there have been significant delays. The process has discouraged other countries that are in need of debt relief from participating under this framework, and it is acknowledged by Bretton Woods institutions that the Common Framework does not work well (Akhtar, Haas, Volz, 2022).

Thus, we propose an alternative framework that enables restructuring existing official debts for more affordable (lower interest rate) long-term financing. To this end, the G20 countries and the

Independent Financial Institutions (IFIs) should explore alternative financing instruments, such as debt-for-SDG swap that includes the SDGs indicators within their framework. Another aspect that should be taken into account in the restructuring framework of the existing official debts is the inclusivity aspect that was missing under the DSSI and the Common Framework. The alternative framework should allow the inclusion of middle-income countries to be eligible to participate in the framework.

Recommendation 5: Integration of blended financing in development financing schemes involving philanthropies and private companies

Another important aspect to note is the massive share of debt of LMICs that is held by the private sector. Therefore, our next proposal is to have greater involvement of the private sector and other players, such as philanthropies, in the development financing scheme. Considering their financing capacity, the private sector and philanthropies would provide more financing room and capacity for the blended financing scheme that could be produced under this proposal. Besides restructuring existing official debts, more utilisation of blended financing will be useful in leveraging development financing alternatives for LMICs.

Recommendation 6: Creation of a coordination and cooperation body involving global, regional and national development financial institutions to create capital aggregation and coordination between institutions involved in development financing

Currently, initiatives with respect to the financing for development agenda are generally taken by institutions, such as the MDBs and the IFIs, at the global and regional levels. Several national institutions are also pushing for greater participation in the development financing agenda. However, all the initiatives are happening in isolation and without substantial synergies among those efforts by different institutions. Considering this, we propose the creation of a coordination and cooperation body involving global, regional and national development financial institutions to create capital aggregation and coordination between institutions involved in development financing. The existence of such a body will enable the synchronisation of agendas by each institution and has the potential to leverage, upscale, and enhance the financing capacity of development financing efforts. Knowledge and information sharing will also enable more strategic and impactful investment by the body members.

Recommendation 7: Establishing national-level development banks in LMICs to finance investment at the sub-national level.

Another key aspect of ensuring the flow of development financing towards LMICs is the demand issue. The supply or availability of funds to invest and support sustainable development agendas has to be matched by a country's ability to deliver its projects. Experience in various projects in developing countries shows that many of them may be socially beneficial but un-bankable. As a result, the private sector will only participate, and donor countries will only assist if the project or investment is made viable.

The gap between the availability of the funds and the ability to utilise those funds in meaningful projects often depends on the institutional capacity of the domestic stakeholders. To address the gap in institutional capacity, we propose the establishment of National-level Development Banks (NDBs) in LMICs. The MDBs and the IFIs will play a role and contribute to the setup of the NDBs to ensure that institutional and technical capacity is adequate to utilise the investment gathered in strategic and productive projects towards the sustainable development agenda. At the same time, operationalisation will rely on the NDBs' own resources. The NDBs will also be responsible for sustainable and development investment at the national and sub-national levels.

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