T20 Policy Brief

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Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Financing Solutions for Developing Countries: Quick Wins

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Abstract

The global financial architecture needs reform for the world to make progress on sustainable development and green industrialisation. Current geopolitical fragmentation and the financial squeeze experienced by several countries make it difficult to act on critical reforms. The clock is ticking for African and other developing economies. Their fiscal space is constrained by rising debt and exogenous shocks are mounting. Economic headwinds limit the financing options for developing countries, further curbed by an "Africa risk premium" and high interest rates on new borrowing. The world is not short of proposals to deal with these challenges, but not enough progress is being made.

There is an urgent need to design macro-critical financing initiatives in such a way that they do not exacerbate the existing debt of several low-income countries (LICs (e.g. climate finance via the Resilience and Sustainability Trust-RST of IMF). The brief highlights short and medium-term actions for the G20, IFIs and development partners to ensure a better deal for developing countries.

The G20 should take decisive action in at least three areas.

First, about 60% of low-income countries are at high risk of debt distress or already in it, according to the World Bank. This compels them to choose between debt repayments or investing in health, education and social protection priorities. The G20's Common Framework (CF) on debt restructuring is not working. It takes too long, excludes middle-income countries and comparability of treatment needs to be clarified.

Second, the issuance of new Special Drawing Rights (SDRs) in 2021 in the wake of the Covid pandemic sought to bolster recovery from the impact of global lockdowns and strengthen health systems. But, apportionment of the SDRs according to the IMF quota system fell far short of needs and meant that only 4% went to LICs, defeating their aim.

Third, IDA20, which had its replenishment frontloaded because of Covid, now faces a financial cliff, and the IDA21 replenishment could see a net decline in contributions.

The policy brief articulates key actions needed:

- overhaul the CF to ease the debt burden of many developing countries,
- rechannel SDRs to provide fiscal space to poor nations,
- strongly replenish the IDA to ensure adequate concessional financing for the SDGs. This should be followed by a strong ADF replenishment.

Diagnosis of the Issue: Decisive points for development finance in 2024-25

With the Indian G20 Presidency, the African Union has joined the G20, representing its 54 member states. While Africa-related issues have been on the G20 agenda for years, the global engagement of the continent of 1.5 billion inhabitants has reached a new stage. Policy challenges in many countries are plentiful as the effects of climate change become more immediate with food security and already overstretched infrastructures under pressure. In many developing countries, and certainly from an African perspective, the urge to provide for basic needs and a decent living is made more urgent by a youthful and ambitious population. Given its predominantly youthful demographic structure, the success of the SDGs will be largely decided on the African continent.

The series of Southern G20 Presidencies – from Indonesia via India and now Brazil to South Africa in 2025 – has provided a unique entry point for engagement. It is in this context that the policy brief highlights short and medium-term actions for the G20, particularly this year and next.

International financial architecture reform and access to concessional finance certainly are key. These are areas of decision-making by the G20 collectively and its individual members that have everyday effects on the lives of people. Social justice, resilience to external shocks, and responding to drastically changing climate patterns require adequate finance. These issues are central to a liveable planet. Progress on the SDGs – or rather fixing the backsliding of the last years – requires reform of the multilateral development system and, more specifically, access to adequate financial resources to allow for investments in the future.

Three key issues require immediate attention:

1. The G20 Common Framework for Debt Treatments

Many countries face debt stress, but there are few quick and viable options to effectively address debt workouts. The G20 created the "Common Framework", but it is too cumbersome for low-income and African countries and needs to be overhauled. Currently, not all creditors participate in comprehensive debt relief, which makes for an unworkable situation. Feasible actions proposed for all concessional finance providers already include incorporating the multilateral development banks in debt relief initiatives, setting standards for participation of private sector creditors, safeguarding access to bond markets in the case of pre-emptive debt restructuring, ensuring a moratorium on debt service payments during restructuring or in the event of a sudden exogenous shock and providing fiscal space for essential spending in affected countries during debt work-outs.

2. International Development Association (IDA) replenishment

Another round of IDA replenishment is upcoming. IDA served as a support to countries during the COVID-19 crisis, and has substantially increased available funds for LICs. Furthermore, it has allowed for grants instead of loans for those countries facing debt distress. Yet, nearly half the countries have not recovered from COVID-19; their GDP per capita is not back to pre-COVID levels.

Admittedly, the prospects for adequate development finance are currently not good, with domestic fiscal constraints and elections in donor economies – not least in the US – limiting the appetite for increases. Most prominently, current wars in Europe and the Middle East seem to be a major obstacle both for the availability of funds and for political understanding of their urgency. G20 members must help ensure a successful IDA21 replenishment by collectively championing IDA21 replenishment globally and encouraging smaller donors to increase their contributions, thereby prompting new donors to join. The aim should be to achieve a tripling of IDA resources by 2030. The economic rate of return on IDA is 1.16 for projects in Africa, which should provide a good foundation for policymakers to advocate for IDA. A strong replenishment of the African Development Bank's African Development Fund (ADF) will also be critical.

3. *IMF Special Drawing Rights (SDRs)*

Rechannelling of SDRs has been approved by the IMF Board of Executive Directors (Use of SDRs in the Acquisition of Hybrid Capital Instruments of the Prescribed Holders). Therefore, the African Development Bank (AfDB) and the Inter-American Development Bank (IDB) proposal for SDR rechanneling should be activated, which will allow the AfDB to leverage resources four-fold. This would mean that $5 billion of rechannelled SDRs to the AfDB could be transformed into an extraordinary $15 to $20 billion of new financing for Africa. Additionally, AfDB has committed to a "carve out" for non AAA-rated African financial institutions to further leverage the rechannelled SDRs and continue building the capacity and balance sheets of the continent's institutions.

Due to legal and technical parameters, five countries must agree to rechannel SDRs together, and it is most realistic for this to be G20 countries.

Recommendations: Quick Wins – Tasks for Global Powers and the G20 Collectively

As argued above, there are proposals to address many of these points. Quick action on these points could serve as focal issues on an African G20 Agenda – and would result in relatively quick gains on urgent points for the continent, increasing the legitimacy of the G20 as a problem-solving mechanism. The points below address all G20 members and the G20 as a club.

On the Common Framework

1. The current framework's timeline and outline of steps need to be clearer, increasing transparency and timeliness of measures before debt default.
2. The eligibility rules should be broadened to include middle-income countries.
3. New rules should also sufficiently protect development investments from austerity measures, in order not to choke off needed growth and a necessary economic transformation.
4. Quicker action by the International Monetary Fund (IMF) to prevent debt defaults is necessary, and should include a climate contingency clause, allowing for a halt on debt repayment in case of natural disasters.

The Marrakech Declaration called for leaders to craft a real solution to the debt crisis that helps African countries swiftly deal with unsustainable debt burdens. In the coming years, African countries will pay an additional US$56 billion on the debt they raised from capital markets over the five years to 2021, compared to what they would pay if they had borrowed from the World Bank instead. Given the scale of debt distress facing African countries, and the ineffectiveness of the existing Common Framework, it is no longer feasible to tweak the current system around the margins.

Countries in debt distress cannot wait years for restructuring and debt workouts. It is critical to better address the role of private creditors in any future debt restructuring framework.

The Marrakech Action Framework, an initiative by African think tanks and development stakeholders, suggests a common framework to resolve the problems of the global financial architecture, serving the African reform agenda and prioritising a debt resolution mechanism with a strong growth component. The framework highlights the need for Africa to:

- build consensus on African borrower coordination mechanisms;
- support engagement with credit rating agencies to address the Africa risk premium;
- support incentivising rules for pre-emptive debt restructuring and ensured debt service suspension; and
- collaborate on research and advocacy among African organisations to document the consequences of the current structure and identify the impact reforms can have on Africa.

On Donor Contributions to Grant Financing Mechanisms

Donors must step up during the IDA21 replenishment to maintain IDA's commitments at their FY22 level of $38 billion over the next two years, and eventually triple their commitments in line with the needs outlined in the Strengthening Multilateral Development Banks: The Triple Agenda report produced by the G20's Independent

Experts Group in June 2023. The IDA21 replenishment due by December 2024 should aim to grow in real terms from the previous replenishment.

The African Development Fund (ADF) replenishment is equally important. Replenishment is scheduled for 2025. President Ruto has called for a $25 billion target, which would be a significant increase from $8.9 billion in the last round. As Africa's own concessional window, a strong replenishment is critical.

1. A number of providers of finance might pledge for increases, for instance, from South Korea or Saudi Arabia, and as a non-G20 member, the UAE. Their actual impact would be at the level of setting a positive tone; however, the substantial increases have to come from traditional donors and emerging powers.

2. African actors have to invest considerable time to convince donors of the need to invest in a common future. Global health and education are worthwhile long-term investments, as well as infrastructure investments in water/sanitation, energy and transport in such a way that they do not worsen existing debt levels. Mindful of the proportion of Africa's population, these areas affect sustainability prospects globally.

3. Finally, the IMF's Poverty Reduction and Growth Trust (PRGT), which supports low-income countries with short-, medium-, and long-term interest-free money to help manage balance of payment challenges, should also be augmented as a critical complementary vehicle for concessional finance and other initiatives such as the Resilience and Sustainability Trust (RST). While the PRGT has been able to provide the equivalent of $24 billion to thirty-nine nations since 2009, it faces a huge gap in pledges, equivalent to $6.3 billion.

On SDRs

4. The G20, under the Brazilian presidency, should rapidly coordinate action on rechannelling of SDRs following the IMF Board approval, thereby providing much needed fiscal space to African nations. Re-channeling SDRs to the African Development Bank will provide much-needed liquidity to African countries and get better value from these assets, as the IMF can lend at less than one-to-one for the SDRs. Successful re-channeling to the AfDB can serve as a model for future re-channeling to other African financial institutions.

In 2021, only five percent or $33 billion of the $650 billion SDR distributed by the IMF went to Africa. The AfDB proposal provides lender nations the ability to withdraw their SDRs, as they would with any other reserve asset, fully meeting the reserve asset criteria. The SDRs would not be exchanged or swapped, but leveraged against their worth.

Scenario of Outcomes

The world needs African countries to return to a robust growth path and focus on transforming economies. The G20 plays a crucial role in ensuring continued concessional flows to address the current fiscal pressures, medium-term debt pressures, and investment in green industrialisation. However, this should not lead to a phenomenon of debt-on-debt by worsening existing debt situations.

G20 commitments should be matched by a strong, consistent and coordinated voice from the African Union (AU) in G20 debates. Engaging with the AU as a new member of the G20 requires action on advanced discussions that have reached a decision point. It also requires a clear focus on the AU side, as leverage remains limited, and thus, only focused action stands a chance of being heard. The AU will need to build internal capabilities – including partnerships with others, such as the Regional Economic Communities (RECs), UNECA, AfDB and think tanks – to effectively engage in G20 processes. G20 countries invest huge amounts of time and money into influencing the contours of collective decisions, and therefore, the AU must also invest in strategically managing this new relationship.

Besides, other G20 states have interests in the continent, too. A clear voice is thus required to identify and stick to priorities. African countries, for their part, will need to shape a consensus amongst themselves in order to effectively push for more funding for development and climate mitigation at G20 gatherings. If the AU were to focus on ripened debates and achieve quick gains in a limited number of areas, it would garner both direct gains for the continent's population and a boost of legitimacy for the continent's engagement in global governance. With this approach, the challenge of a regional organisation that needs to balance numerous interests on the continent could turn into a tangible gain for states to bring their voices together.

This could also generate additional thrust for a more profound debate on the global financial architecture and the continent's weight in it. IMF quota revisions, for instance, require new analysis. The upcoming South African G20 Presidency should push for an expert working group to look into a fair African quota for representation in the global financial architecture. The new G20 seat can also advance discussions that are relevant to Africa's long-term development, such as the role of credit rating agencies, the human and social costs of a financial architecture that is not sensitive to the needs of developing countries, climate finance and global taxation.

Ultimately, all of these actions can contribute to the goal of reducing poverty, providing decent jobs, and ensuring healthy and educated children on a planet that remains habitable. The World Bank Global Economic Prospects 2024 notes that even with expected strong economic rebounds, including growth of 4.1 percent in 2025 in sub-Saharan Africa, it will be inadequate for major progress in reducing extreme poverty. By 2025, per capita gross domestic product (GDP) for 250 million people in Africa will not have returned to levels prior to the COVID-19 pandemic. This means that financing needs remain at extraordinarily high levels when official development assistance is declining and many countries have limited access to the global bond market.

In the context of the G20, these trends can have global impacts. Ongoing violence in Sudan, Ethiopia, the Democratic Republic of Congo, and Nigeria, as well as recent coups in Gabon, Niger, Burkina Faso, Guinea, Chad and Mali, often point to the lack of opportunities for young people, the weaknesses of institutions, and the tenuous hold of liberal democracy in Africa. Reforming the global financial architecture is only one step in helping to address these challenges, but a stronger and more equitable financial system is the only viable option for ensuring countries have access to more finance more quickly.

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