T20 INDONESIA 2022 THINK

Policy Brief

A PROPOSAL FOR A BLENDED-FINANCING FRAMEWORK FOR RECOVERY AND ACCELERATED SUSTAINABLE TRANSITION

Task Force 9

Global Cooperation for SDG Financing

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Abstract

Whilst the COVID-19 pandemic continues its successive waves worldwide, the eruption of the war in Ukraine has disrupted the global economic recovery. Low-income countries (LICs) and lower-middle-income countries (LMICs) will face major financial and economic challenges to alleviating the social cost of the pandemic, together with rising food and energy prices, whilst committing to the net-zero scenario and complying with the United Nations Sustainable Development Goals (SDGs).

We propose a public-private sustainable finance fund/plan as part of the global economic recovery plan to accelerate the sustainable transition. This proposal extends a previous proposal[1] introducing a mechanism, which includes the private sector, aimed at restructuring the existing piles of sovereign debt and interest and extending it to finance a sustainable recovery, compliant with the SDG principles whilst committing to the net-zero scenario. Extending this mechanism and making it mapped and compliant to SDGs via the introduction of an environmental, social and governance (ESG) matrix would reduce uncertainty about the sustainable transition, economic hardship from the potential disorderly restructuring and sovereign debt opaqueness and would facilitate private sector involvement in financing the sustainable transition that is fully SDG-compliant. At the same time, it would commit to sovereign debt transparency and monitor and place these countries on a post-COVID-19 recovery path that is also SDG compliant.

[1] *https://www.g20-insights.org/policy_briefs/debt-relief-for-sustainable-recovery-in-low-and-middle-income-countries-proposal-for-new-funding-mechanisms-to-complement-the-dssi/*

Challenges

In 2019, the global sovereign debt increased sharply[2]. By 2020, it had become clear that debt service in low-income countries (LICs) and lower-middle-income countries (LMICs) was a structural issue[3]. The COVID-19 pandemic has exacerbated indebtedness and distress[4]. An increase in debt and a reduced capacity to carry and service it has resulted in increasing vulnerabilities, raising the probability of default and ensuing risks to economic growth and financial system stability.

In April 2020, a Debt Service Suspension Initiative[5] (DSSI) was launched under the World Bank Group (WBG) to address debt vulnerability in the poorest countries, to enable the freeing up of some fiscal space to combat the health crisis and its consequences. The implementation of the DSSI was accompanied by the monitoring of spending, promoting public debt transparency and ensuring prudent borrowing. However, the lack of debt transparency remains a major obstacle to restructuring and relief efforts involving the private sector, despite the ongoing initiatives to enhance debt transparency, such as the OECD debt transparency initiative launched in 2021[6].

The lack of transparency was explored by Ayadi and Avgouleas[7] (2020), who called for a sovereign debt registration repository[8] that would be publicly accessible following re-authorisation and would complement the ongoing efforts of international organisations. It is also a cornerstone for private sector involvement to manage orderly restructuring, as was described in a more recent paper on the topic[9].

In their paper Altuwaijri, Altuwaijri and Ayadi[10] (2021) outlined the key challenges stemming from the increasing debt levels in LICs and LMICs and described the initiatives launched under the auspices of the Group of 20 (G20), mainly the DSSI, which expired in December 2021. The

[2] https://www.imf.org/en/Publications/GFSR/Issues/2019/10/01/global-financial-stability-report-october-2019
[3] https://g20.org/en/media/Documents/G20_FMCBG_Communiqu%C3%A9_EN%20(2).pdf.
[4] https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020
[5] https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative
[6] https://www.oecd.org/finance/debt-transparency/
[7] https://t20saudiarabia.org.sa/en/briefs/Pages/Policy-Brief.aspx?pb=TF8_PB6
[8] The repository will be called the Debt Transparency Platform[8] (DTP), powered by blockchain technology, where all bilateral, multilateral and private sector players can register sovereign debt transactions.
[9] https://www.g20-insights.org/policy_briefs/debt-relief-for-sustainable-recovery-in-low-and-middle-income-countries-proposal-for-new-funding-mechanisms-to-complement-the-dssi/
[10] https://www.g20-insights.org/policy_briefs/debt-relief-for-sustainable-recovery-in-low-and-middle-income-countries-proposal-for-new-funding-mechanisms-to-complement-the-dssi/

DSSI contributed to suspending US$12.9 billion in the debt payment of 48 out of 73 eligible countries[11], with little success in attracting the solid participation of the private sector. In November 2021, the Common Framework[12] for debt treatment beyond DSSI was endorsed by the G20, together with the Paris Club, to support LICs with unsustainable debt. However, to date, the Common Framework (CF) does not seem to have delivered as expected. The experiences of Chad, Zambia and Ethiopia show that there is a margin of improvement for the CF to function efficiently and there were calls from the International Monetary Fund (IMF)[13] to step up its action and improve its process.

To date (June 2022), the global challenges have not faded away and the debt challenges are becoming more pressing. The pandemic continued its successive waves worldwide in 2021 and the war in Ukraine erupted in 2022, disrupting global economic recovery and adding further hardship to LICs and LMICs. Surging energy and food prices, increased indebtedness and inflationary pressures and, in a context of gloomy economic growth, the risks of defaults and stagflation are becoming the pillars of a looming crisis scenario. According to the IMF GFS Report[14] (2022), the average public debt to gross domestic product (GDP) ratio increased worldwide, particularly in emerging markets; this ratio accounted for 67 percent in 2021 from 52 percent before the pandemic, due to government support plans to respond to the global pandemics and its economic consequences. The report also warned that the nexus between sovereigns and banks had become more complex, due to increasing interdependencies with the real sector during the pandemic. The pandemic has, indeed, accelerated sovereign indebtedness of all countries worldwide, due to unprecedented policy measures, including accommodative monetary and fiscal measures such as cash transfers, equity injections, loans and guarantee programmes. The war in Ukraine exacerbated the negative spirals, according to the IMF[15], via surging energy and food prices and overall rising uncertainty and poor market confidence. This trend will undermine global recovery and will drive vulnerable LICs and LMICs closer to default, with disastrous economic and social consequences.

Beyond these challenges, the sustainable transition towards a net-zero scenario will put further financing pressures on LICs and LMICs, particularly those countries that are net importers of fossil fuels. In the transition phase to a net-zero scenario, the cost of energy might further increase in view of a prolonged war in Ukraine. Additionally, to accelerate the transition, there are colossal financial needs of adaptation and mitigation of climate change

[11] https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative
https://clubdeparis.org/sites/default/files/annex_common_framework_for_debt_treatments_beyond_the_dssi.pdf
[13] https://blogs.imf.org/2021/12/02/the-g20-common-framework-for-debt-treatments-must-be-stepped-up/
[14] https://www.imf.org/en/Publications/GFSR/Issues/2022/04/19/global-financial-stability-report-april-2022
[15] https://blogs.imf.org/2022/03/15/how-war-in-ukraine-is-reverberating-across-worlds-regions/

(accounting for between $5 million and $7 trillion annually, according to an estimation of the UN in 2014)[16]*, whilst transforming the economies that currently rely on the extraction of natural resources to circular and green economies that rely on clean energy sources and innovative waste management mechanisms. Globally, the world's domestic savings accounted for $22.86 trillion as of 2020, according to the World Bank data, which, in theory, could be sufficient to fulfill these financing needs. However, the unequal and inefficient allocation of these savings may hinder the financing of a sustainable transition, particularly for the less developed countries. The UN report of 2014 provided ample policy options (115) ranging from domestic, international, private, public and blended instruments to finance the sustainable transition.*

In view of the current challenges facing the world and, in particular, the LICs and LMICs that have become more vulnerable because of the successive shocks (e.g., pandemic and war in Ukraine) since 2020, it has become an absolute necessity to act decisively to avert massive defaults that could erase decades of economic and social development in these parts of the world. Acting decisively might become a challenge as well because of the disruption in global cooperation due to the war in Ukraine and the world position on the sanctions imposed on Russia.

[16] https://www.un.org/esa/ffd/wp-content/uploads/2014/12/ICESDF.pdf

Proposals for G20

In the absence of comprehensive global financing and a resolution framework for a sustainable transition, a systemic debt crisis is neither very far away nor is it expected to be managed effectively, whilst driving LICs and LMICs into a long and painful transition that will sidetrack them from achieving the United Nations Sustainable Development Goals (SDGs) and a real commitment to the net-zero scenario. The costs will be dire for the countries that will have to restructure or default on their sovereign debts, having managed their sustainable transition in line with the SDGs and the Paris Climate Agreement. Post-default restructurings are indeed associated with larger declines in GDP, investment, private sector credit and capital inflows than pre-emptive restructurings[17] whilst the SDGs will not be achieved. Poverty and inequality, already exacerbated during the pandemic,[18] will continue rising, risking years of development in the LICs and LMICs.

In a previous paper [19] published in 2021, Altuwaijri, Altuwaijri and Ayadi proposed a public-private financing fund/plan as part of a global economic recovery plan post-COVID-19, fully aligned with the 2030 Agenda for sustainable development, to complement the DSSI and to be extended to LICs and LMICs. This mechanism can be used to restructure the existing piles of sovereign debt and interest and to finance a sustainable recovery.

The authors explained that this mechanism would reduce uncertainty, economic hardship and sovereign debt opaqueness and would facilitate private sector involvement in large restructurings and participation in coordinated debt relief, as well as post-COVID-19 recovery efforts aligned with the 2030 Agenda, whilst fully committing to sovereign debt transparency and monitoring, placing these countries in a post-COVID-19 recovery and sustainable path for development.

In April 2022[20], acknowledging the detrimental effect posed by the challenges from the pandemic, the spillovers from geopolitical shocks and long-term structural issues faced by LICs and LMICs, which impeded them from achieving a stable balance of payments and resilient and sustainable growth, the Executive Board of the IMF approved the establishment of the Resilient and Sustainability Trust (RST), which took effect from 01 May 2022.

[17] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3557035
[18] https://blogs.worldbank.org/opendata/impact-covid-19-poverty-and-inequality-evidence-phone-surveys
[19] Altuwaijri, Altuwaijri and Ayadi (2021) https://www.g20-insights.org/policy_briefs/debt-relief-for-sustainable-recovery-in-low-and-middle-income-countries-proposal-for-new-funding-mechanisms-to-complement-the-dssi/
[20] https://www.imf.org/en/Publications/Policy-Papers/Issues/2022/04/15/Proposal-To-Establish-A-Resilience-and-Sustainability-Trust-516692

According to the report published by the IMF, "*the RST will complement the IMF's existing lending toolkit by focusing on longer-term structural challenges—including climate change and pandemic preparedness—that entail significant macroeconomic risks and where policy solutions have a strong global public good nature. It will channel Special Drawing Rights (SDRs) contributed by countries with strong external positions to countries where the needs are the greatest, providing policy support and affordable longer-term financing to strengthen members' resilience and sustainability and thereby contributing to prospective balance of payments stability. The RST will be a loan-based trust, with resources mobilised on a voluntary basis*".

"*About three quarters of the IMF's membership will be eligible for longer-term affordable financing from the RST, including all low-income countries, all developing and vulnerable small states, and lower middle-income countries. Access will be based on the countries' reforms strength and debt sustainability considerations and capped at the lower of 150 percent of quota or SDR 1 billion. The loans will have a 20-year maturity and a 101⁄2-year grace period, with borrowers paying an interest rate with a modest margin over the three-month SDR rate, with the most concessional financing terms provided to the poorest countries. The RST will stand ready to commence lending operations once a critical mass of resources from a broad base of contributors is achieved and once sufficiently robust financial systems and processes are in place, which is anticipated to occur by the end of 2022. Fundraising toward the estimated total resource needs of about SDR 33 billion (equivalent to US$45 billion) will be initiated immediately*".

The establishment of the RST is a step in the right direction towards financing sustainability and resilience of the LICs and LMICs, via affordable loans supported by channelling the unallocated SDRs from advanced economies. However, since January 2022, the debt challenges faced by LICs and LMICs are more pressing after the abrupt disruption of the global recovery due to the war in Ukraine and the risks posed by increasing inflation, pressures to lift interest rates as well as lower than expected growth rates. These challenges were loudly emphasised by the head of the IMF in her statement[21] at the 2022 Spring IMF-WB meetings. Many countries (e.g., Lebanon, Tunisia, Sri Lanka, El Salvador and Ghana) were heading towards a default scenario[22] and having to negotiate bailout programmes with the IMF, against economic reforms that may not be popular in times of economic hardship, particularly the lifting of food and energy subsidies when energy and food prices are skyrocketing. In its current form, the RST does not allow the provision of

[21] https://www.imf.org/en/News/Articles/2022/04/14/sp041422-curtain-raiser-sm2022
[22] Organisations such as Eurodad called for action on sovereign debt: https://www.eurodad.org/calls_for_action_on_sovereign_debt

guarantees to enhance the leverage of trust or to provide the right incentives to encourage the private sector to get involved.

The expiry of the DSSI in December 2021 and the poor functioning of the Common Framework could undermine the efforts to deal with the sovereign debt issue in many vulnerable LICs and LMICs, which will have detrimental consequences on their development path at a time when global challenges and crises are the norms. The RST may not be enough to deal with the financing needs of the countries in distress and it does not help much when the countries are facing default, particularly in the absence of a functioning instrument such as the DSSI.

The war in Ukraine is creating further challenges to Ukraine, Europe and the world economy. Ukraine will lose a significant percentage of its output and will require massive help to face the budgetary and migration crises. Europe is facing a huge increase in the price of energy and the current sanctions on Russia will further increase the costs because of European dependence on oil and gas. The conflict with Russia will generate more uncertainty and less confidence in the European economy. These new costs will weigh on the capacity of developed countries to reallocate their SDRs to emerging and less developed countries that are facing debt distress[23]. In addition, the war and the sanctions against Russia are undermining global cooperation and, subsequently, the functioning of international institutions such as the G20, the IMF and the WBG. This new context, tarnished by acrimony and walkouts, will make difficult any new agreements relative to the support of emerging and less developed countries that are facing distress. The new scenarios of global and/or regional cooperation are uncertain and will weigh largely on a resuming global recovery. If no peace deal is formulated between Ukraine and Russia, the future of global cooperation is bleak. In such a case, regional groupings, including the West, will take the lead in organisations such as the IMF and the WBG, whilst the East will see the emergence of new institutions with different mandates, policies and rules. The G20, which includes countries from both West and East will face an uncertain future. This position was confirmed by the IMF chief economist, who, when interviewed by the Financial Times *on April 22, 2022, said," if we become a world of many different blocs, we will have to undo a lot of the integrated economies that we have built, including the supply chains and build something else that is more narrow and smaller in scope… if we are in a world in which we have different blocs, then I don't exactly know how the IMF can function. Does it become an institution that works for one bloc but not the others? How does it work across different part of the world?"*

[23] *According to the IMF, the spreads over US treasuries are above 1000 basis points by April 2022.*

Taking all these new challenges into account and despite the high level of uncertainty, our proposal is to extend the timeline of the DSSI until a post-COVID-19 global recovery resumes and the war in Ukraine ends with a peace deal with Russia and to enlarge the eligibility of the LMICs. The DSSI should systematically engage with the private sector to contribute to the debt relief efforts and get their assurance that the countries benefitting from debt relief will not be excluded from the capital markets for new issuances. Whilst the CF could become a permanent instrument to inherit the temporary nature of the DSSI after expiry, it has to improve its clarity, be more transparent and provide a clear roadmap to the countries that engage in debt relief negotiations. Countries that access the DSSI must credibly commit to registering all forms of new debt in the Organisation for Economic Cooperation and Development (OECD) debt transparency repository[24]. In line with the proposal of Altuwaijri, Altuwaijri and Ayadi (2021), we propose to complement the DSSI with a public-private SDG-compliant financing fund/plan as part of a post-COVID-19 global economic recovery plan, to accelerate the transition towards a net-zero scenario and to fully comply with the SDG principles and relevant indicators.

This mechanism can be used to restructure the existing piles of debt and interest and to finance a sustainable recovery and transition towards the SDG objectives and towards a net-zero scenario[25].

The mechanism could take the form of a partial guarantee (between 40 and 60 percent) issued by the RST, that has the financial capacity - thanks to the SDR allocation - to help LICs and LMICs issue long-term maturity (up to 50 years) recovery, resilience and sustainable transition bonds (RRST Bonds), with lower interest rates (no more than 1 percent above market interest rate levels on the dollar[26]) to exceptionally transform their existing unpaid debt and to finance their recovery plans post COVID-19 and allow a sustainable transition to 2050 in line with the SDGs. It is essential that the private sector, represented by the Institute of International Finance (IIF), contributes with a firm written commitment to provide affordable liquidity within a period of time for these countries.

The DSSI and RST must work in close coordination with the private sector, represented by the IIF executive board. Coordination must be achieved via a tripartite task force with the country in difficulty to co-design a comprehensive financing approach for recovery, resilience and sustainable transition. This will be considered as a collective approach to avoid massive defaults

[24] https://www.oecd.org/finance/debt-transparency/
[25] Other proposals have been vocal in adopting a coherent global approach to deal with sovereign debt in emerging and developing countries. https://eprints.soas.ac.uk/34346/1/DRGR-report.pdf
[26] Undoubtedly, the pressure to increase interest rates to tackle high inflation might hurt a resilient recovery and may lead to higher interest rates on issuance in US dollars.

of countries that have succumbed to their structural problems, exacerbated by the COVID-19 pandemic and the war in Ukraine.

The terms and conditions of the prospectus for the RRST bonds must be agreed up front, when the DSSI country has completed the debt relief process and committed to the conditions of the RRST. The main conditions of the RRST are to use a predetermined percentage (up to 20 percent) of the proceeds of the bond to finance the unpaid debt that subsequently matures; the remaining 80 percent must be allocated to the recovery and sustainable transition in line with the RST conditions, with very strict monitoring of the use of proceeds and a firm commitment to publish the debt issued and the breakdown of its use in the debt transparency repository of the OECD.

The RST conditions are fully aligned for eligible countries to engage in reforms for sustainable transition (through complying with the SDG principles) and achieving the net-zero scenario. These reforms will encompass climate adaptation, mitigation and sound, transparent public investment and financing management, as well as preparation for future pandemics.

These partial guarantees will enable the IMF, via the RST, to leverage its financial capabilities via the SDR system and to monitor the issuance and the use of the raised funds at these unprecedented times. The private sector will have incentives to invest in the RRST with a reduced rate, as it is partially guaranteed by the RST. These mechanisms are not new. In 2015, Ghana issued a $1 billion sovereign bond, partially guaranteed by the WBG,[27] to improve macro-fiscal stability and to attract foreign direct investment into the extractive sector and power-generation projects.

The countries issuing the RRST Bonds must justify that they are using resources for recovery post-COVID-19 and for the sustainable transition by ensuring that reforms are credible and all economic actors are fully compliant with the SDG principles, which will carefully match national ESG policies and indicators that are recognised by a reputable international agency (preferably a UN agency) and systematically monitored annually. The countries must be committed to full transparency on previous and future sovereign debt and the use of proceeds from these bonds for recovery and sustainable use. This will have to be monitored and audited by the IMF and other official public registries, e.g., the OECD, and reported to the public.

[27] https://www.worldbank.org/en/news/feature/2015/11/18/new-world-bank-guarantee-helps-ghana-secure-us1billion-15-year-bond#:~:text=The%20sovereign%20bond%20is%20partially,conditions%20for%20emerging%20market%20issuers .

The countries that have accessed the DSSI and are willing to fund their post-COVID-19 recovery and sustainable transition and access to the capital markets under these conditions should comply with the terms of the plan. In the long run, this plan will allow more countries to access capital markets and will enhance the transparency of the use of funds for productive use and, hence, will reduce the incidence of corruption and will enhance accountability and improve governance.

An explicit financing plan, available to LICs and LMICs, for which the conditions would be agreed upon globally, would reduce uncertainty in the recovery and sustainable transition, economic hardship and sovereign debt opaqueness and would facilitate private sector involvement in large orderly restructurings and participation in coordinated post-COVID-19 recovery efforts, as well as a credible sustainable transition towards SDGs on the 2022-2050 horizon, whilst fully committing to the net-zero scenarios and to sovereign debt transparency, monitoring and placing these countries on a post-COVID-19 recovery and sustainability path. The G20 could lead the discussion and implementation of this financing plan in close coordination with the IMF and would, hence, prepare the ground for accelerating the sustainable transition, in cooperation with the private sector and extending and complementing the role of the DSSI.