Chair International Architecture of Development Finance

Fourth of the events organised by FERDI in preparation for the June Paris Summit on Financing for Development in Vulnerable Countries

Avoiding a new debt crisis: financial engineering or development dynamics?

7 April 2023 - 14:00 / 17:30 - Paris

Location: Banque de France

Context

FERDI

Since its creation, FERDI has made international development finance its priority programme. At the same time, it has carried out a great deal of work on country vulnerability, its different forms, their measurement and how they were or could be taken into account in international development finance. Ferdi is internationally recognised for its expertise on issues of country vulnerability and its links to financing.

In addition, since the beginning of the year, FERDI has created a Chair on the "International Architecture Development Finance " (IADF) under the direction of Philippe le Houérou, Chairman of the Board of Directors of AFD and former CEO of IFC, and with the participation of a select group of French personalities with considerable experience in the field and an equal desire for reform, all intervening in their personal capacity: notably Rabah Arezki, former Chief Economist and Vice President of the African Development Bank; Bruno Cabrillac, Deputy Director General of Studies and International Relations, Banque de France; Sylviane Guillaumont Jeanneney, Professor Emeritus, former member of the Board of Directors of the AFD; Alain de Janvry and Elisabeth Sadoulet Professors at the University of California at Berkeley, Senior Fellows at Ferdi; Olivier Lafourcade, former Director at the World Bank; Alain Le Roy, Ambassadeur de France and former Under Secretary General of the United Nations; Jean-Michel Severino, Chairman of Investisseurs et Partenaires (I&P) and former Director General of the AFD. The purpose of the group was to reflect independently on what the global development finance system should become in the light of the current international situation and the lessons learned from the past 60 years. The announcement made by the President of the French Republic of a Summit to be held in Paris on the financing of vulnerable countries with a view to adopting a Financial Pact with these countries has led the IADF Chaire to adapt, accelerate and amplify its programme so as to make contributions on themes that are crucial to the orientation of the Summit.

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Banque de France

The Banque de France is strongly involved in international discussions and forums on the international financial architecture and the fight against climate change, in particular with regard to the consideration of these issues in the monetary and financial sectors. The risks associated with climate change are indeed a source of financial risk that must be analysed and addressed by central banks and supervisors. In particular, the BDF is in charge of the secretariat of the NGFS (*Network of Central Banks and Supervisors for Greening the Financial System*) since its creation in 2017, which aims to share best practices among peers; to contribute to the development of climate and environmental risk management in the financial sector; and to mobilise conventional finance in order to support the transition towards a sustainable economy. The Banque de France has also been instrumental in integrating climate change considerations into the Eurosystem's monetary policy operations. In addition, the Banque de France is developing an ambitious research agenda on financial risks related to climate but also to biodiversity, to refine our understanding of these complex risks.

The Banque de France is thus actively participating in the preparation of the Paris Summit in June 2023.

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Finance for Development Lab

The Finance for Development Lab is an independent non-profit, non-partisan think-tank dedicated to building a fairer and more effective architecture for international finance. Acting as a hub for policy discussions, the Lab collaborates with think-tanks, researchers, and other key stakeholders across the Global South to generate constructive ideas, craft innovative proposals, and influence global policymakers, with a particular focus on G20 countries and Bretton Woods institutions. The Lab is housed at the CEPREMAP, a leading French research institute located within the Paris School of Economics.

The Lab's mission is to fill existing knowledge and perception gaps by serving as a specialised research and discussion forum specifically focused on development finance and debt related issues. We do so by collaborating with research partners across the Global South, and disseminating recommendations among international decision centres. To achieve our mission, we provide experts in developing countries with research support, and with assistance in disseminating and channelling their ideas and policy proposals as effectively as possible.

The event of 7 April: Avoiding a new debt crisis: financial engineering or development dynamics?

The fourth event of the Chair is on the theme of debt.

This session will consist of two parts:

Roundtable 1: Debt sustainability in the context of climate change

Climate change has both immediate and long-term consequences for the debt trajectories of developing countries. Their high physical vulnerability to global warming and to increasing natural disasters, combined with lower socio-economic resilience (food and agricultural insecurity, high population growth, lack of social safety nets, political instability), puts a strain on public finances at a time when they already have little fiscal space. Financing the energy transition represents a major financial challenge for the sustainable development of these countries. According to UNECA, the investments required for the energy transition in African countries are in the order of 500 billion dollars by 2030. Climate change adaptation needs, which appear more immediate and higher in relative terms than in developed countries, also increase the debt burden. For African countries, the financing needs for climate change adaptation are estimated at US$ 438 billion by 2030 (Songwe et al., 2022). Climate change financing needs are thus a key component of the financing needs for sustainable development.

At the same time, climate change is affecting the investment and debt capacity of developing countries. Losses in economic growth due to climate change may limit their borrowing capacity, while rising climate risks put upward pressure on the cost of market finance, for example in the form of climate risk premiums, in the range of 65-120 basis points (Geneva 25: Climate and Debt, 2022). This scissor effect, between rising financing needs on the one hand and less financing available at a higher cost on the other, underlines the central role played by international financial institutions (IMF, development banks), whose concessional financing constitutes an important part of the financing available for developing countries and represents a real financial safety net for these countries. This is illustrated by the gradual development of multilateral financing tools dedicated to the fight against natural disasters or climate change (CMAF Report, 2019, pp. 33-41), and in particular the establishment in 2022 of the IMF's *Resilience and Sustainability Trust*.

The question of the sustainability of public debt with regard to climate change is a central issue for low-income countries, along three possible lines:

- **The first refers to the proper consideration of the expected economic, social and environmental returns from investments undertaken for both adaptation and the energy transition, particularly the growth gains linked to the climate transition**. The implementation of development strategies based on investments in infrastructure is not new. This development model, which has been successfully adopted by many Asian countries, has also been replicated in a number of low-income countries. There are many international initiatives to promote infrastructure investment in developing countries, from the recent G7-led *Partnership for* Global *Infrastructure and Investment*, to the European Union's *Global Gateway* strategy, or to China's *Belt and Road* initiative. The aim is not only to prevent developing countries from being caught in poverty traps, which would also exacerbate political instability and conflicts, but also to catalyse private investment and ensure adequate financing of common goods, particularly environmental goods.

- **The second regards the tools for assessing medium and long-term debt sustainability, in particular the debt sustainability analyses conducted by the IMF and the World Bank.** The integration of the climate dimension in these analyses is essential, with a view to mobilising and catalysing external financing (official and private), or to orienting the debt strategies of debtor countries in the medium and long term. The adoption of adapted methodologies for the treatment of climate risk and the implementation of climate stress tests are avenues to be considered for refining the DSA. Extending the time horizon of debt sustainability analyses also seems essential in order to take into account physical and transition risks as well as investments that reduce them. The inclusion of private creditors on the one hand and domestic debt on the other, whose weight is growing, is also essential. Finally, transparency is a determining factor for the credibility and support of creditors, both in terms of debt sustainability analyses and responsible debt strategies of debtor countries.

- **The third relates to the objectives and modalities of active public debt management, in order to avoid debt treatments.** The increase in debt-related risks in low-income countries (60% of LICs are at high risk or in debt distress in 2022, compared to 30% in 2015), in a context of exacerbated climate challenges, leads to the implementation of active public debt management policies, as part of medium- and long-term strategies aimed at maintaining debt sustainability while integrating climate issues. A great deal of thought is being given to how to meet this dual challenge, as shown by the debate on contingent debt instruments, which will be the subject of the next round table. Debt-for-climate swaps are also an interesting avenue, although they have remained limited for the moment.

Questions for discussion :

- *What impact does climate change have on the debt trajectories of developing countries? How can the investments needed for sustainable development be made on affordable terms?*
- *How can the climate dimension be better integrated into debt sustainability analyses, in particular by taking into account the horizons of climate adaptation or transition investments? How to include domestic debt, while existing monitoring tools are generally focused on external sustainability?*
- *How can public debt management take into account the climate dimension? What role for debt-for-climate swaps? How can international financial institutions intervene?*

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Roundtable 2: Instruments for a contingent debt treatment

Global risks – macroeconomic, environmental, geopolitical – have risen. This in turn, makes debt more vulnerable, especially for emerging and low-income countries. As those countries were severely affected by the economic and social consequences of the Covid-19 crisis, the mobilisation of the international community and the G20 countries led to the implementation of the Debt Service Suspension Initiative, which released some liquidity for eligible countries. However, this kind of initiative remains ad hoc, while the increase in external shocks (such as natural disasters, pandemics) calls for the implementation of more automatic and permanent mechanisms.

To deal with shocks in bad times, a broader toolbox is necessary. It could include the development of state-contingent debt instruments (SCDIs), for which interest has re-emerged, but also enhancing the ability of institutions such as the IMF to mobilise resources in a more countercyclical manner. Innovative instruments could allow debtor countries to differ payments during a prescribed period in the event of an external shock, providing automatically liquidity relief that would allow the redirection of funds intended for debt service to immediate needs. Such instruments will need to overcome the traditional problems, which hampered the development of SCDIs in the past decades. Those include complexity in defining triggers (which should be timely, transparent, and outside of the control of parties) and lack of liquidity, which often leads to high premiums. Another route is to enhance rapid assistance instruments such as the IMF's Food Shock Window, or other insurance schemes under natural disasters or macroeconomic shocks.

Borrowing countries, as well as lenders, whether official or private, stand to benefit from enhanced risk sharing. This session will discuss the possibility of making those instruments a reality. Recent progress has been made on natural-catastrophes clauses, which offer liquidity relief to debtor countries during shocks, including pandemics in the latest version. Barbados issued a bond with natural catastrophes and pandemic clauses. In November, in the run-up to COP 27, the International Capital Market Association (ICMA) announced a template for Climate Resilient Debt Clauses (CRDCs) in sovereign bonds.

On the official side, the Agence Française de Développement (AFD) has been offering to clients to borrow from “Prêt Très Concessionnel Contra-cyclique” (Very Concessional Countre-cyclical Loans) with mixed success for 15 years, but this approach is coming back in fashion with UK Export Finance launching CRDC clauses as well in its offering.

Additionally, in the context of sovereign debt treatment, oppositve perspectives between lenders and borrower often need to be reconciled around improved risk-sharing. Chad’s debt treatment within the Common Framework provides an innovative example of contingent treatment.

This session will offer an opportunity to evaluate those innovations from multiples perspectives: from borrowing countries and creditors, whether in the bilateral, multilateral or private sectors.

Guiding questions for the panel:

- *How can we improve policies for protecting countries from exogenous shocks? What is the ability of multilateral development banks and the International Monetary Fund to provide lending surges?*
- *What debt instruments should best deal with climate and other crises? How do they compare, compete or complement with other risk-sharing devices?*
- *Can multilateral lenders also adopt climate or other shocks-related clauses ? Will the market accept generalised NPV-neutral instruments? What can the Paris summit achieve in this regard?*