Status check: Managing debt sustainability and development priorities through a 'Big Push'

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Executive summary

Emerging market and developing economies (EMDEs) have seen development prospects fade in the two years since the onset of COVID-19. Growth turned negative in 2020, is forecast to snap back in 2021, but then revert to a declining trend.[1] Investment levels in Latin America and Africa are forecast to remain in the range of 20-25 percent of GDP in the medium term. Outside of Asia, prospects for growth and for convergence with advanced economies are dim. Unlike in advanced economies, the GDP trajectory in EMDEs post-COVID-19 is significantly lower than pre-COVID-19 estimates; 31 developing countries may have lower levels of GDP per capita in 2025 than in 2019.

Meanwhile, general government debt levels in EMDEs have risen by 9 percentage points of GDP. At current low levels of world interest rates, the debt service implications are manageable for most countries, but risks remain if inflation causes major central banks to raise interest rates. As a result, EMDEs are under pressure to cut public spending, even in face of higher needs to respond to the pandemic.

The present trajectory, therefore, is one of slow growth, low investment and public spending, and rising debt service burdens in many, if not most, EMDEs. There is significant risk that this trajectory will prove unsustainable for economic, social, or political reasons.

The current trajectory is also highly inefficient, with high-return projects in EMDEs left unfunded due to debt overhang considerations, and highly inequitable, with poor and vulnerable countries and populations left to manage the pandemic with limited support.

Global aspirations for a universal transformation to a low-carbon economy and a “just transition” are not likely to be met in the current baseline scenario for the global economy because EMDEs are central to both objectives and without additional public spending neither transition will happen.

There is another way forward, one that offers better prospects for global growth and equity, with lower risks of systemic debt defaults. Rather than relying on austerity, it is a path that seeks to accelerate green, inclusive and resilient growth. This path takes advantage of historically low prices of energy, made possible by technological advances in renewables, and of historically low interest rates on international capital markets to undertake a “big push” to transform economic structures and accelerate growth.

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1 IMF (2021), World Economic Outlook Database, October 2021

There are four key ingredients of the "big push" approach.

First, a set of investments needs to be identified to achieve the desired transformations. The country-by-country analytical work on which this paper draws suggests that EMDEs (ex-China) should be increasing their investment rates by about 3-4 percent of GDP above pre-pandemic levels in order to provide adequate growth of zero-carbon energy and infrastructure, sustainable agriculture, forestry, and land use (AFOLU), adaptation and resilience, and human capital. This translates into incremental annual investments of about $1.3 trillion by 2025, and more thereafter.

Second, a financing plan is needed that is aligned with the types of expenditures being considered. The proposal advanced here is for an even split between domestic and external financing. The latter, in turn, can be mobilized from ODA, multilateral and other official financial institutions, and private capital. These are not fully fungible—each has a role to play.

Domestic resource mobilization is a core component of any investment strategy. It is essential for general purpose financing like human capital and recurrent spending on nature and adaptation. Thus, a key part of the big push strategy is improving developing country tax administrative capacity, while reducing fossil fuel subsidies. The needed increase of 2.7 percentage points of GDP is well within the range of possibilities identified by the IMF. Additional revenues may accrue from new regulations governing base erosion and profit shifting (BEPS), but the current G-20 agreement may not yield much for many developing countries in the medium term. Stronger international efforts are also needed to stem illicit financial flows and encourage greater information sharing between tax authorities in advanced and developing countries.

Concessional finance is needed to help poor countries, to promote equity, and to incentivize countries to invest adequately in global public goods that have international spill-overs—for example, mitigation, nature, and pandemic preparedness. Bilateral donors have already pledged to double climate finance from $30 to $60 billion, and agreement seems likely on a $100 billion IDA20 replenishment by year's end. However, more is needed. ODA in 2020 from DAC countries amounted to only 0.32 percent of their GDP. A new collective agreement is needed to back the transformational change that is proposed here. Our approach calls for a 50 percent increase in concessional finance relative to 2019 levels, an incremental $96 billion by 2025. This is equivalent to 0.15 percent of donor GDP.

Our proposal is not just a call for more ODA, defined as money designed to promote the welfare of developing countries. As the past year has shown, weak health systems and pandemic surveillance in one country have global repercussions. The point is that provision of concessional finance for implementation of global public goods in developing countries benefits advanced countries as well as developing countries. Our proposal calls for a mixture of ODA and a fair funding of global public goods on concessional terms.

Multilateral finance and other official finance. Multilateral development banks (MDBs) are able to offer lower cost loans at longer maturities than other lenders, making debt more sustainable. They could stretch their current balance sheets by making better use of callable capital and reforming statutory lending limits – perhaps freeing up headroom for an additional $750 billion to $1.3 trillion of loans. Other reform efforts, including balance sheet optimization, greater risk pooling, greater use of blended finance and guarantee facilities, and asset sales could also help expand MDB lending. Our proposal calls for MDBs to triple their lending levels, from $63 billion in 2019 to $189 billion by 2025.

Private capital can be attracted into sustainable infrastructure projects, which generate revenue streams to cover equity returns and the debt service associated with the project. There are currently both supply and demand side obstacles that have prevented the scale-up of greater private investment in developing countries: a lack of bankable projects, and a limited appetite for long term investments with perceived high risk. New institutional innovations, such as the development of country platforms, standardized processes, and experience with risk-mitigating official finance suggest that a rapid ramp-up in private finance is now feasible. Our proposal calls for an approximate doubling of the 2019 level of private finance for infrastructure in developing countries by 2025. MDBs and other development partners will need to be more pro-active to mobilize and catalyze private finance on this scale.

The third element of the "big push" is policy and institutional reform in countries to ensure that investments generate maximum returns. These reforms are partly sectoral (carbon equivalent taxes and removal of fossil fuel subsidies are clear examples) and partly cross-cutting. Reducing corruption and bureaucratic red tape, increasing voice and citizen participation, and consideration of gender issues are examples. Many countries have the capacity to absorb far larger amounts of investment than they actually receive. To illustrate, the IMF's public investment management assessment scores African countries at 4.4 compared to 4.5 for Asia. Yet Asian countries profitable invest 15 percentage points of GDP more than African countries. The dispersion in scores is large, suggesting some countries have considerable room to improve, but equally suggesting that other countries have reasonable policy frameworks in place already.

The fourth and final element of the "big push" is international coordination. A "big push" will not work without a concerted global plan and agreement. In some cases, this reflects the need for global policy coordination—the BEPS agreement, proposed measures for carbon taxes and standardized approaches in blended finance are examples. More fundamentally, however, international coordination is needed to change mindsets about appropriate policy. No finance minister in an EMDE will support a big push strategy if this is not approved by the international financial institutions that s/he will rely on to provide needed resources. No private investor will willingly provide funds into a high-debt situation without clarity on how debt work-out mechanisms will operate. No civil society advocate will support a big push without greater transparency on how funds will be spent by their government.

All this suggests the need for a process of consensus building around how to scale up cross-border financing. There are many ongoing discussions and ideas for strengthening parts of the system, but less has been done on forging a common approach so that all parts of the system act in a linked-up fashion. There must be international oversight of core recovery programs, the building of consensus around which individual actors can orient their actions, and the inclusion of regional partners to augment the voice of developing countries. Transparency will be a crucial pillar of any financial architecture reform effort.

The response to COVID-19 thus far has bought us some time, but it is far from enough. The world faces a host of looming medium-term challenges in addition to the short-term imperatives of managing COVID-19 and ensuring recovery. Foremost among these are a low-carbon transition, increasing biodiversity and nature needs, growing adaptation and resilience challenges, and a large deficit in human capital spending. Big problems require big solutions. A stepped-up “big push” investment of around $1.3 trillion in EMDEs by 2025 would enable greater spending on all of these global challenges. A financing strategy must match the right source of financing to each of these needs and deliver this in a timely fashion to enable transformational change over the next decade. The moment is ripe for greater international collaboration and action. In 2020, advanced economies spent over $12 trillion on domestic response efforts. In the next decade, we must mobilize a similarly ambitious effort to tackle a global response.

1. Introduction

In March/April of 2020, a sudden stop of private capital flows to developing countries led to capital flight of about $100 billion, about the same amount as during the full year of the Asian Financial Crisis in 1997. Foreign direct investment (FDI) fell by 35 percent in 2020, and though it recovered somewhat in 2021, it is still projected to remain 25 percent below 2019 levels.[2] Greenfield investment project announcements, one form of FDI, were down by 42 percent in developing countries in 2020, and equity investments flows fell by 50 percent. This all contributed to a 10 percent slowdown in gross fixed capital formation in developing countries (ex-China) in 2020.[3]

Almost a year and a half into the COVID-19 pandemic, much progress has been made. Many advanced economies have started to rebound, and unemployment is starting to fall. Vaccination efforts are underway globally, and some advanced economies are close to herd immunity. Though six countries have defaulted since the pandemic began (Argentina, Ecuador, Belize, Lebanon, Suriname, and Zambia[4]), this has not led to the wider scale sovereign defaults that many feared, and the international financial community has mobilized a large influx of cash into developing countries to help stem the worst of the economic fallout. The pandemic aggravated debt service problems in many countries through its effects on trade, commodity prices, and tourism, but defaults were contained to countries with pre-existing weak policies and economic management.[5]

Yet not all has returned to normal. Vaccination efforts in developing countries have been slow and may stall further if advanced economies choose to offer a third booster shot for citizens. The economic recovery, meanwhile, has been uneven. The International Monetary Fund (IMF) estimates that 41 countries will see real GDP per capita in 2025, in 2017 PPP terms, below 2019 levels.[6] Ten are high-income, leaving 31 developing countries who are likely to experience long-term scarring from COVID-19. This uneven and weak progress in developing countries is largely attributed to a lack of fiscal space. Compared to advanced economies that have added 16.3 percent to their gross general government debt through larger fiscal deficits and below-the-line public loans, guarantees, and other support for firms, emerging markets have only had space to

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[2] UNCTAD (2021). *World Investment Report 2021: Investing in Sustainable Recovery*. Geneva: UNCTAD.
[3] World Bank (2021). *Global Economic Prospects.* Washington, DC: World Bank.
[4] Pham (2021). "EM Sovereigns: Debt sustainability remains a concern but will only become acute for some." ING, Jan. 7.
[5] Kraemer et al. (2021). "Default, Transition, and Recovery: 2020 Annual Sovereign Default and Rating Transition Study." S&P Global.
[6] IMF (2021). World Economic Outlook – April 2021. Washington DC: World Bank.

expand by 9.7 percent, while low-income countries have been restricted to 5.2 percent.[7] Though many countries avoided an all-out default, developing countries did see their creditworthiness deteriorate: 36 developing countries had their credit rating downgraded by one of the three major ratings agencies in 2020, and an additional 28 have had their outlook downgraded.[8]

In this paper, we attempt to take stock of where we are in the recovery effort. We look at policy efforts to date to stem the worst of the short-term debt and development crises, and then assess what still needs to happen to help vulnerable developing countries get over the hump. Beyond short-term relief efforts, we argue the international community must also start to focus on the long-term recovery agenda in order to bring about the level of transformational change needed on human capital, sustainable infrastructure, agriculture and land use, and adaptation and resilience. We then lay out a road map for future progress, identifying which actors in the international system are best poised to help deliver a "big push" investment to address various outstanding components of the short- and long-term recovery agenda.

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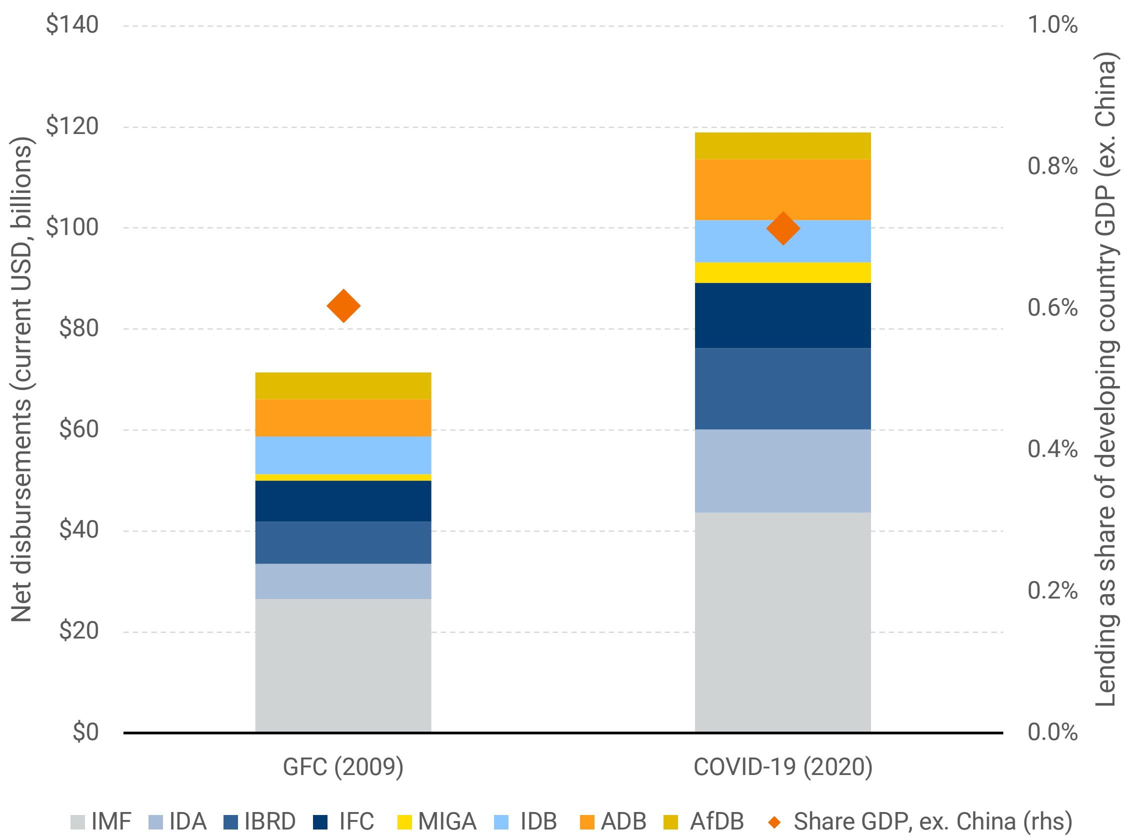
[7] IMF (2021). Fiscal Monitor – April 2021. Washington DC: World Bank, p. 4.
[8] See Fitch, Moody's, and S&P Press Releases, accessed Jan. 28, 2021.

2. Policy response to date

2.1. International Financial Institution (IFI) COVID-19 response

The international community responded rapidly to the sudden outflow of private capital in developing country markets in March 2020. The major international financial institutions (IFIs) were able to disburse $120 billion in net terms in 2020, with the IMF playing the largest role. As Figure 1 below shows, this represented an increase in absolute volumes as well as an increase in the share of developing country GDP, as compared to the response during the global financial crisis (GFC) of 2008-2009, a response that was warranted as the depth of the global economic downturn and the number of affected developing countries was far more severe in 2020.

Figure 1. IFI Net Disbursements to EMDEs during the Global Financial Crisis and COVID-19



Source: World Bank quarterly financial reports, IMF financial query system, ADB annual reports, IDB annual reports, and AfDB annual reports. Totals exclude lending to high-income countries where possible.

The overall response of the IFIs was sizable but uneven. Low-income countries were provided considerable additional support—through the Debt Service Suspension Initiative (DSSI) (discussed below), the sharp ramp-up in IDA grants and credits, and a large increase in disbursements from the IMF's Poverty Reduction and Growth Trust (PRGT). The incremental support offered to middle-income countries, including many of the most vulnerable countries, was, however, much lower. Figures 2a and 2b below show the *change* in disbursements in each of the crisis years compared to the preceding year—a better proxy for the crisis-related component of new disbursements, separate from the ongoing long-term trends in disbursements—for the IMF's General Resource Account (GRA) and the World Bank's IBRD (mostly targeted towards middle-income countries) and PRGT and IDA (mostly targeted towards low-income countries).

The first panel shows that in both the 2009 and 2020 crises, the IMF and World Bank stepped up their financing compared to the previous year. Panel 2 shows that the incremental response from the concessional windows of the IMF (PRGT) and World Bank (IDA) were proportionally larger than the response from the non-concessional windows (GRA and IBRD). Taken together, the data suggests that middle-income countries that are not eligible for IDA or PRGT funding received less immediate support in 2020. This may be a result of pressure from major shareholders. Secretary Mnuchin is reported to have told World Bank and IMF management to "manage financial resources judiciously and transparently so as not to burden shareholders with premature calls for new financing."[9]

[9] Reuters (2020). "U.S. Treasure chief urges IMF, World Bank to use resources judiciously." Reuters, October 14.

Figure 2a. Change over preceding year in World Bank and IMF net disbursements during GFC (2009) and COVID-19 (2020), by income group

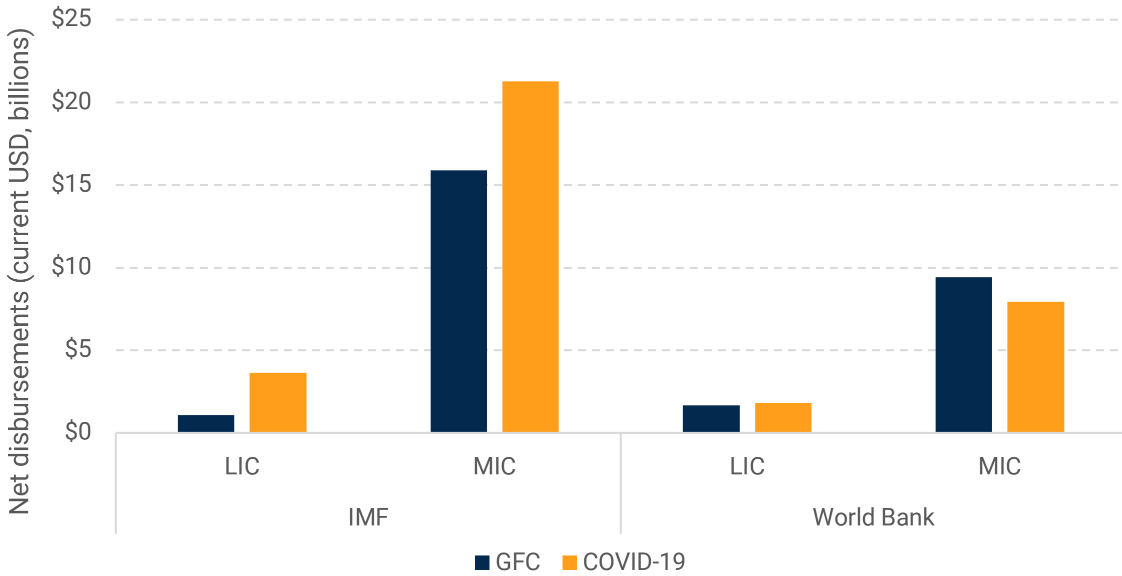
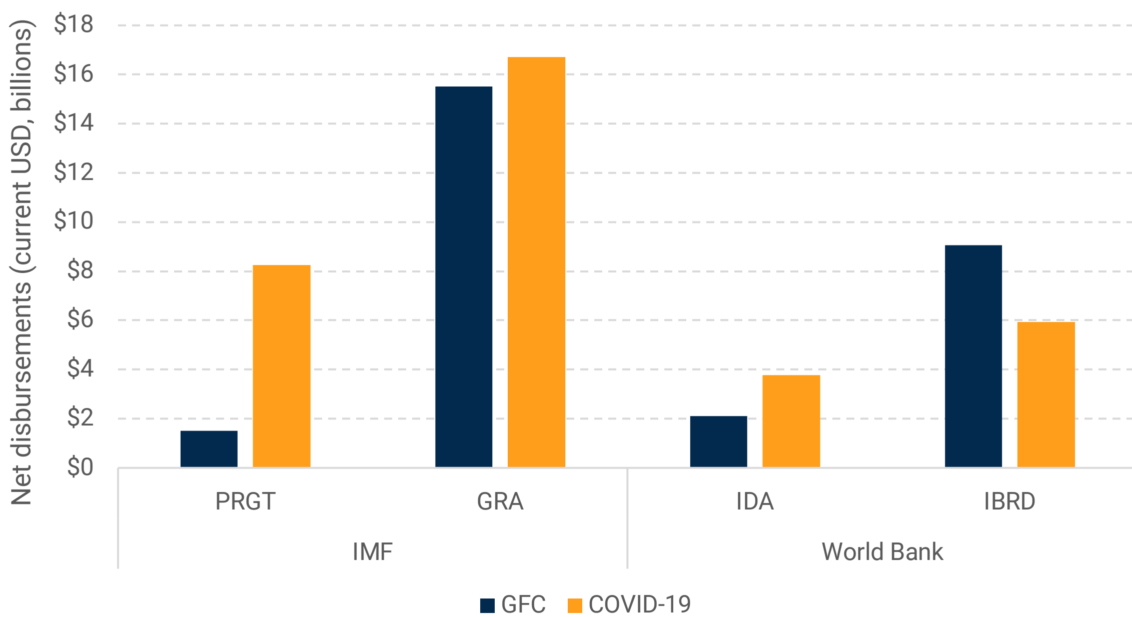


Figure 2b. Change in World Bank and IMF net disbursements during GFC (2009) and COVID-19 (2020), by type of funding



Source: World Bank quarterly financial reports and IMF financial query system. For IMF, graph reports change in lending from 2008-2009. For World Bank Group, graph reports change in lending from 2009-2010. Totals exclude lending to high-income countries.

2.2. DSSI/Common Framework

In response to the massive global capital outflows in developing countries at the start of the pandemic, as well as falling tourism and remittances, the G-20 agreed to a temporary debt standstill on bilateral debt service for IDA eligible countries plus Angola. This program, the Debt Service Suspension Initiative (DSSI), has been extended twice, and is now set to expire permanently in December 2021. Of the 73 eligible countries, 48 have requested debt service relief, with $6 billion saved in 2020,[10] and a potential savings of $10 billion in 2021.[11]

The DSSI was designed to address short-term liquidity crises brought on by the pandemic. And indeed, it has provided fiscal breathing room for some countries; for example, Ethiopia was able to direct saved funds towards PPE, contact tracing, and hospital equipment. However, the initiative left out many vulnerable and tourism-dependent middle-income countries. Furthermore, there is some fear that countries used DSSI savings to pay back their private creditors and bondholders, rather than redirecting savings towards pandemic response efforts.

In November 2020, the G-20 also agreed to a shared framework to help countries in need of larger-scale debt restructuring. This program, the Common Framework for Debt Treatment, is open to DSSI eligible countries and designed to address longer-term solvency issues. Countries can seek relief under the framework on a case-by-case basis. Needs are determined by IMF and World Bank debt sustainability analysis, and bilateral creditors agree to fair burden sharing, meaning debtor countries must seek relief on similar terms from all creditors (other than multilateral institutions with preferred creditor treatment), including the private sector. It is notable that a number of non-Paris club creditors like China, India, Turkey, and Saudi Arabia signed onto the agreement. Thus far, Chad, Ethiopia, and Zambia are the only countries to request relief under the Common Framework.

The Common Framework marks an important step forward in providing a coordinated mechanism for further debt relief, requiring debtors to seek equal treatment from all creditors. However, it is not easily scaled to cover multiple countries in an equitable fashion and the initiative is still only open to IDA eligible countries, leaving many middle-income countries with larger-scale debt restructuring needs without an avenue for redress.

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[10] IMF (2021). "Questions and Answers on Sovereign Debt Issues." Last updated 8 April 2021.
[11] Wheatley (2021). "G-20 extends debt relief for low-income countries until end of this year." Financial Times, April 7.

2.3. COVAX/Aid

Surprisingly in light of all the other demands on developed country budgets this year, foreign aid looks to have held steady in 2020 according to preliminary OECD figures. Net bilateral official development assistance (ODA) from Development Assistance Committee (DAC) bilateral donors and multilateral funds reached $161 billion, a rise of 3.6 percent in real terms or a $6 billion increase over 2019. However, to put that in perspective, rich countries spent an incremental $12 trillion to support their own economies and populations in 2020, meaning that aid accounted for just 0.05 percent of the aggregate response to the pandemic. Aid allocations in 2020 did not deviate substantially from previous years with a 4 percent increase in aid to Africa, a 2 percent increase to least developed countries, and a 6 percent increase to humanitarian aid.[12] $12 billion of this total was for COVID-19 response efforts, $9 billion of which was from the European Union.

One major aid focus this year has been on equitable vaccine access. The Access to COVID-19 Tools (ACT) Accelerator was established early last year to enable global collaboration on the development, production, and distribution of COVID-19 tests, treatments, and vaccines. As of October 15, 2021, this initiative had mobilized $18.9 billion, leaving a funding gap through the remainder of 2021 of $15.8 billion.[13] A core pillar of the ACT-Accelerator is the COVAX vaccine facility, which aims to pool vaccine procurement across countries to ensure equitable distribution. It also aims to raise money to cover part of the cost of vaccines for low and middle-income countries. So far, COVAX has delivered 371 million doses to 144 countries.[14] The initiative has secured 1.9 billion doses in 2021, and an additional 0.9 billion in 2022.[15] Advanced economies have also agreed to donate excess doses from their own domestic vaccination efforts to COVAX, with 1.4 billion doses pledged so far.[16] While this news is encouraging, so far vaccine distribution has been far from equitable. 77 percent of shots have gone to high-income and upper-middle-income countries, with just 0.5 percent going to low-income countries.[17]

While the focus on domestic needs is understandable, the economic multipliers associated with a concerted global vaccination effort are immense. Targeted spending on domestic cash transfer programs, for example, have multipliers of 0.9–1.3, whereas

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[12] OECD (2021). "COVID-19 spending helped to lift foreign aid to an all-time high in 2020 but more effort needed." Press Release, April 13.
[13] WHO (2021). "Access to COVID-19 tools funding commitment." Funding Snapshot, October 15.
[14] GAVI (2021). "COVAX vaccine roll-out." Last updated October 18.
[15] Nguyen (2021). "What does COVAX's latest supply forecast tell us?" GAVI, June 23.
[16] G-7 (2021). "Carbis Bay G-7 Summit Communique." June 13; UNICEF (2021). "Global leaders commit further support for global equitable access to COVID-19 vaccines and COVAX." Press release, September 23.
[17] Holder (2021). "Tracking Coronavirus Vaccinations Around the World." New York Times, updated October 18.

the multipliers from ACT-Accelerator spending range from 40 to 166.[18] Greater burden sharing among advanced economies is not only the right thing to do, but is in their own self-interest as it will help stem the spread of new variants from low-vaccination countries.

2.4. New SDR issuance and potential reallocation

On August 23, 2021, the IMF issued $650 billion equivalent in new Special Drawing Rights (SDRs) to its members. SDRs are a global reserve asset, which can be exchanged for real tradable currency to meet liquidity needs. SDRs were distributed based on existing IMF quotas, roughly proportional to the size of their economy. Developing countries, excluding China, got $173 billion in the new SDR allocation, 27 percent of the total. Upper-middle-income countries (UMICs) received $99 billion (15 percent), lower-middle-income countries (LMICs) received $65 billion (10 percent) and low-income countries (LICs) received $9 billion (1 percent) (see Table 1).[19]

This new issuance will provide developing countries with needed liquidity support and room to carry out more expansionary monetary policy. Countries have different institutional arrangements that dictate whether and how central bank reserves can be drawn upon by fiscal authorities, especially in cases where central banks are independent, but indirect mechanisms are available if there is agreement on policy direction. For heuristic purposes, we look at the size of SDR allocations compared to debt service due in the next five years and compared to the level of GDP in the next five years, to assess the implications for creditworthiness and fiscal expansion respectively.

If all of the SDR issuance was allocated to debt service payments, the new allocation would cover 12 percent of debt service due over the next 5 years. If all were allocated to additional spending, the allocation is equivalent to incremental spending of 0.2 percent of GDP per year for five years. This share is higher for low-income countries, who could cover 21 percent of upcoming debt service payments, or 0.4 percent of GDP in sustained new spending, with their new allocation.

G-20 leaders have backed the recent $650 billion SDR allocation and have supported IMF Staff proposals to on-lend surplus SDRs through existing IMF initiatives, like the PRGT, and through a new Resilience and Sustainability Trust (RST), which could lend to vulnerable middle-income countries to support an IMF-agreed program of general government spending on specific priorities, potentially including climate adaptation or biodiversity preservation. IMF Staff indicate an expected demand from the RST of $30-

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[18] WHO (2021). ACT-A prioritized strategy and budget for 2021. Geneva: WHO.
[19] Based on World Bank FY22 income groupings.

50 billion, but the Trust will only be accessible by low income and vulnerable middle-income countries, and only to those with an IMF program in place. These constraints could limit demand.

Table 1. New SDR allocation to developing countries by country grouping, compared with total external debt service, public and publicly guaranteed, due 2021-2025 and GDP

Region	SDR allocation ($bn)	% total allocation	Debt service 2021-2025 ($bn)	Ratio SDRs/ 5 year debt service	GDP 2021-2025 ($bn)	Ratio SDRs/ 5 year GDP
Africa	$34	5%	$258	13%	$15,392	0.2%
East Asia & Pacific	$22	3%	$194	11%	$17,586	0.1%
Europe & Central Asia	$31	5%	$238	13%	$15,671	0.2%
Latin America & Caribbean	$47	7%	$490	10%	$25,772	0.2%
Middle East	$16	2%	$112	14%	$12.444	0.1%
South Asia	$24	4%	$203	12%	$22,039	0.1%
Upper-middle income	$99	15%	$818	12%	$53,747	0.2%
Lower-middle income	$65	10%	$635	10%	$53,143	0.1%
Low-income	$9	1%	$41	21%	$2,111	0.4%
Investment grade	$79	12%	$632	12%	$54,799	0.1%
Speculative grade	$69	11%	$624	11%	$46,574	0.1%
Substantial risk	$25	4%	$239	11%	$7,627	0.3%
Total ex-China	$173	27%	$1,495	12%	$109,000	0.2%

Source: IMF (2021) and World Bank International Debt Statistics (2021). Regional and credit worthiness ratings exclude high-income countries. GDP 2021-25 in current USD terms, based on latest IMF WEO projections (October 2021).

2.5. Policy commitments

In addition to pledging to donate excess vaccine doses to COVAX, the G-7 has also reiterated their support for a $100 billion climate pledge to help developing countries manage the green transition.[20] This $100 billion per year target from now until 2025 is a global goal, combining financing from both public and private sources across all developed countries.

The G-20 has likewise supported calls for additional multilateral development bank (MDB) lending in the wake of COVID-19. During the July 2021 Finance Minster's meeting, they called for an independent review of the MDB capital adequacy frameworks to complement an earlier workstream reviewing measures to enhance balance sheet optimization.[21,22] The MDBs' current lending approach will not change without shareholder support, and the G-20 makes up a sizable majority at each of these institutions.

The U.N. has likewise led global efforts to mobilize additional resources for the COVID-19 response effort. The Secretary General has issued a three stage response effort: respond to the immediate health crisis, safeguard lives and livelihoods by addressing the economic fallout from the pandemic, and jumpstart a transformative recovery effort to address larger issues of climate change, inequality, sustainable food systems, and the SDG agenda.[23]

To finance these aims, the U.N. put forth the Strategic Preparedness and Response Plan to address health needs, requesting $1.7 billion in 2020 and an additional $1.96 billion in 2021 (60 percent funded as of Oct. 2021).[24] They also launched a Global Humanitarian Response Plan under OCHA to deal with the socioeconomic and humanitarian component, requesting $10.3 billion in 2021 (40 percent funded as of Oct. 2021).[25] Finally the U.N. has put forward a framework to support recovery efforts over the next 12 to 18 months, with initial requirements of $1 billion.[26]

The U.N. Secretary General has also drawn attention to the twin debt and development crises in many developing countries. He has urged the international community to continue to put new resources into countries to finance response and recovery efforts and provide liquidity support for countries facing a short-term balance of payments

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[20] G-7 (2021). "Carbis Bay G-7 Summit Communique." June 13.
[21] G-20 (2017). "G-20 Finance Ministers and Central Bank Governors Meeting Communique." March 18.
[22] G-20 (2021). "Third Finance Ministers and Central Bank Governors Meeting Communique." July 9-10.
[23] United Nations (2020). United Nations Comprehensive Response to COVID-19: Saving Lives, Protecting Societies, Recovering Better. New York: UN.
[24] WHO (2021). "Coronavirus disease (COVID-19) donors & partners: WHO says thank you!"
[25] OCHA Financial Tracking Service (2021). "COVID-19 Global Humanitarian Response Plan."
[26] United Nations (2020). A UN framework for the immediate socio-economic response to COVID-19. New York: UN.

crisis due to the pandemic.[27] On the debt front, he has called for extending the DSSI until the end of 2022 and including middle-income countries in the initiative, building on the Common Framework to expand eligibility and build out a more permanent debt resolution framework, and restarting conversations around international debt architecture reform. In his most recent report, *Our Common Agenda*, he has called for a Sustainable Development Goal investment boost and for a resolution of weaknesses in the debt architecture.[28]

[27] United Nations (2021). Liquidity and Debt Solutions to Invest in the SDGs: The Time to Act is Now. New York: UN.
[28] United Nations (2021) Our Common Agenda. New York: UN

3. What's missing from the global response to date

Due to the stepped-up engagement of the IFIs, debt standstill under the DSSI, vaccine commitments through COVAX, the new SDR allocation, and G-7, G-20, and U.N. commitments, the world has averted a catastrophic economic collapse for the time being. Thanks to globally coordinated international policy, we have avoided a massive string of defaults, as was originally feared. Developing countries have been given some fiscal space through both debt standstills and SDRs to purchase vaccines, PPE, and support to the hardest hit in their communities. In essence, the efforts to date have bought some time, giving countries some breathing space, but underlying stresses of economic recession, development setbacks, investment collapse and debt service risks remain significant and unaddressed.

Two questions thus emerge: 1) Have global policy measures done enough to stop the short-term risk of default and economic collapse in vulnerable developing countries? 2) What still needs to be done to enable longer-term recovery efforts, including stepped up support to enable a transition to sustainable and inclusive growth in developing countries?

3.1. Have efforts to date done enough to stop short-term risks of default and economic collapse?

3.1.1. Rising debt service obligations

The DSSI has postponed around $6 billion in debt service payments over the past year, allowing the 48 developing countries currently participating in the initiative to direct these resources towards other pressing needs, like health expenditures. Yet this amount pales in comparison to the $1.5 trillion in upcoming debt service payments that developing countries, excluding China, owe over the next 5 years.

Not all these countries are in danger of failing to make these payments. We find that 42 percent of debt service is owed by 11 investment grade developing countries (BBB- and above), who are likely to be able to meet these obligations or refinance them on international markets.[29] Another 42 percent is held by 73 speculative grade countries (B-

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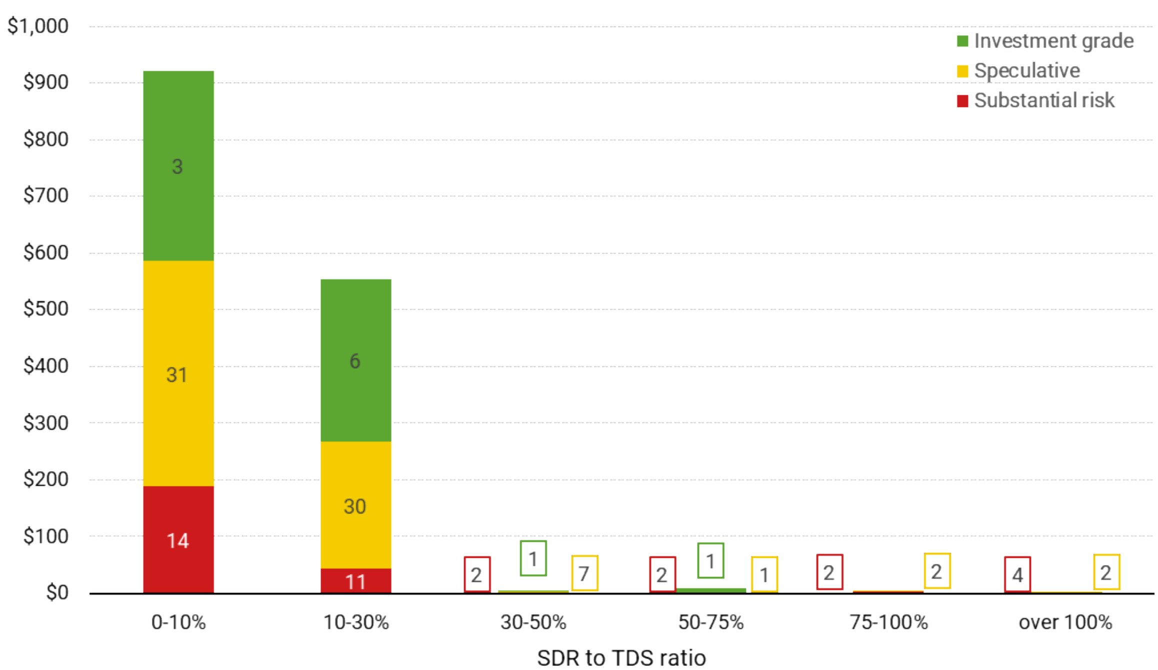
[29] Using credit ratings from Trading Economics, an aggregator of ratings from the major ratings agencies. Ratings as of April 2021. Countries with missing credit scores interpolated based on Kharas and Noe (2018).

to BB+) whose ability to make payments depends in part on global capital market conditions—risk premia, monetary policy in major economies, and global economic and COVID-19 developments. Several of these countries went into COVID-19 in a weak economic position. Because of their speculative grade creditworthiness, they may need official international support in the coming years. 45 countries in this group are already eligible for the DSSI, leaving 28 without a means for redress. In addition, 12 substantial risk credit rating countries (CCC+ and below) are not eligible for the DSSI, of which 5 have already defaulted.

Referencing Table 1 above, we find that around 11 percent of speculative and substantial risk countries' upcoming debt service obligations could be covered by the new SDR allocation. Looking at country by country estimates, we find that 22 speculative and substantial risk countries will have at least 30 percent of the debt service covered by SDRs, with 6 countries (Algeria, Central Africa Republic, Iran, Liberia, Somalia, and Zimbabwe) receiving SDRs in excess of their debt service obligations (see Figure 3). However, the vast majority of developing countries received an SDR allocation that will not be enough to materially offset debt service obligations if downside economic risks occur.

Figure 3. SDR allocation as a share of total external debt service, public and publicly guaranteed, due 2021-2025

Total debt service due in billions USD, and number of countries in each category (labels)



Source: IMF (2021) and World Bank International Debt Statistics (2021).

Thus, while the world has not seen a widespread debt crisis yet, a liquidity crunch could occur if economic growth remains low over the next few years.

With the DSSI set to expire at end-2021 and given the large number of non-DSSI eligible countries that may encounter debt servicing difficulties, there is an urgent need to prepare for an eventuality where multiple countries may need to reschedule. More broadly, the international debt resolution mechanism, rooted in finding consensus among Paris Club members, needs a new set of principles and discussion forums to forge agreements between debtors and all creditors, including private creditors and non-Paris Club members.

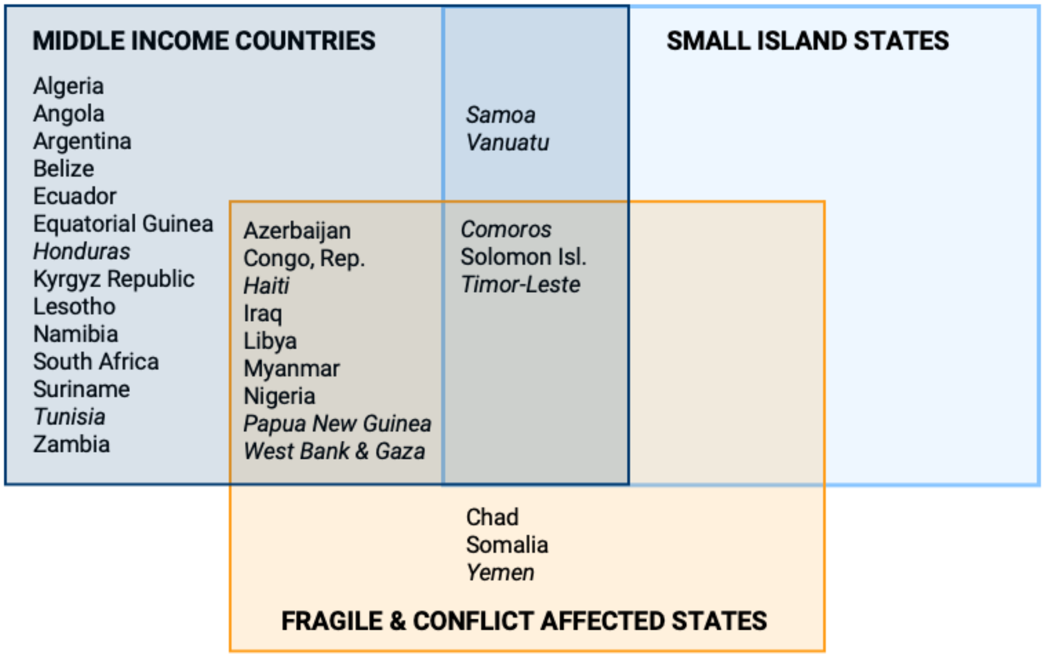
3.1.2. Limited fiscal support for hard-hit countries

Despite recent improvement in the global economic outlook, the IMF estimates that 41 countries are likely to see lower GDP per capita in 2025 than 2019, measured in 2017 PPP terms. 31 of these are developing countries. These countries, where the economic scarring from COVID-19 is set to be longest lasting, are most in need of more public spending to promote recovery and they may need additional international support to finance such recovery efforts.

Figure 4 looks at the profile of this group of 31 hardest-hit developing countries. They are predominantly middle-income, small island states that have been heavily impacted by a loss of tourism, and fragile and conflict-affected states. Ten are members of the V-20, climate-vulnerable countries who are likely to need additional adaptation and resilience support under any green transition agenda. Eighteen are speculative grade countries and 12 are at substantial risk of default (Libya is not rated). Five countries in the group have already defaulted, and Chad has sought debt relief under the G-20 Common Framework.

Figure 4 shows the breakdown of countries among these groups and the overlap between them.

Figure 4. Countries with lower GDP per capita in 2025 than 2019 by country grouping



Source: Authors' calculations based on IMF April WEO database of GDP per capita in 2017 PPP dollars.
Countries in italics are members of the V-20.

This hardest-hit group of developing countries collectively received $27 billion in SDRs, an amount that opens up fiscal space equivalent to an additional 0.21 percentage points of GDP per year for 5 years. The distribution of this is, however, uneven. Three countries received SDRs equivalent to 5 percent of GDP, allowing an additional 1 percentage point in spending over the next few years (Libya, Suriname, Zambia). An additional 6 countries received SDRs allowing for an additional 0.5 percentage points of spending per year (Kyrgyz Republic, Lesotho, Samoa, Somalia, Vanuatu, Yemen). The remaining countries received rather small allocations in relation to GDP.

Another way to look at the relative size of the new SDR allocation is to compare it to the amount of ODA countries receive. Among the LIC and LMIC countries in this hard-hit group, Belize, the Republic of Congo, Nigeria, and Zambia received SDRs in excess of their 2019 ODA disbursement. Of the remaining LICs, Chad received 4 months' worth, Yemen 2 months' worth, and Somalia a little over 1 month.

SDRs are thus not a panacea to this group's economic growth problem and spending constraints. In most instances, they will not provide enough fiscal space to permit a rapid recovery. This group of 31 hard-hit countries will likely need other forms of international support to recover, and still larger amounts to finance the investment expansion required to enable the green transition and complementary and overlapping investments in human capital and nature conservation.

3.1.3. Additional access and support for vulnerable middle-income countries

Some countries are highly vulnerable to global economic shocks, largely as a result of geography or an undiversified economy. A group of 48 countries forms part of the V-20, a group of climate vulnerable states, including low-and middle-income, landlocked, and small island developing countries. These countries are individually small but collectively significant. They have 1.2 billion people, an aggregate GDP of $2.3 trillion (about one-tenth of all developing countries, ex-China), and account for 5 percent of global carbon emissions. Because of their vulnerability, they face obstacles in accessing private capital markets, so must rely more heavily than other countries on official sources of finance.

In addition to their current vulnerability, some V-20 countries have very large spending needs to adapt to climate change and to make their economies more resilient. These are estimated at up to 10 percent of GDP;[30] V-20 countries by themselves are unlikely to be able to finance this level of spending without international support and may have to cut back on spending if access to capital markets deteriorates with rising risks.

Yet many of these countries have been excluded from recent debt efforts, including the DSSI and G-20 Common Framework, which were limited to low-income countries. More efforts are needed to specifically target this group. A number of proposals have been put forward, including the new Resilience and Sustainability Trust resourced by a reallocation of surplus SDRs and an ECLAC proposal for a Caribbean Resilience Fund.[31] Civil society organizations, supported by several small-island state governments, have put forward a proposal for a Climate Damages Tax (CDT).[32] This would be a levy on each ton of coal, oil or gas extracted, the proceeds of which could be used to defer the costs of extreme weather hazards in vulnerable countries. Regardless of the mechanics, a priority should be a better understanding of country vulnerability and the development of mechanisms to manage it.

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[30] UNEP (2021). Adaptation gap report 2020. Nairobi: UNEP.
[31] Barcena (2020). "Remarks by Alicia Barcena, Executive Secretary of the Economic Commission for Latin America and the Caribbean (ECLAC), at the Meeting of Finance Ministers Convened by the United Nations Deputy Secretary-General and the Finance Ministers of Canada and Jamaica, 8 September 2020."
[32] Richards et al. (2018). "The Climate Damages Tax: A guide to what it is and how it works." Stamp Out Poverty, Practical Action, and WWF.

3.2. What still needs to occur to enable longer-term transformational recovery efforts?

Current trends would leave developing countries on a lower growth trajectory than before the pandemic, with sharply lower investment levels. Governments would need to put in place severe austerity measures to meet debt service obligations. The risk of social and economic instability along this path is high.

Yet there is an alternative path, one that takes advantage of the historically low real interest rates on global capital markets, coupled with the historically large opportunities for technological leapfrogging represented by low prices for renewable energy. After World War II, for example, debt/GDP ratios in advanced economies came down sharply thanks to rapid growth fueled by government spending. For developing countries today, transformation rather than reconstruction is the major challenge, but the same opportunities present themselves for plentiful high social return investment in sustainable infrastructure, nature, adaptation and resilience, and human capital.

3.2.1. Stepped up investments in sustainable infrastructure

Thanks to improvements in technology, the transition to a sustainable and inclusive economy "provides the greatest economic, business and commercial opportunities of our time."[33] However, average investment rates as a percent of GDP since 2000 in Eastern Europe (23 percent), Latin America (20 percent) and sub-Saharan Africa (21 percent) are simply too low to permit an economic transformation on the scale required.

As the latest IPCC report illustrates,[34] the world is out of time—we must step up investments now in order to move from a high carbon to low carbon economy to stave off the worst impacts of a 2° C warming increase.

Advanced and developing countries alike will need to scale up investments in sustainable infrastructure to manage key transitions and deliver on development and climate outcomes in a host of sectors, including energy, transportation, water, food and land use, and industry. Some of these investments will be net neutral for financing—decreasing investments in fossil fuels frees up resources to invest in green energy sources. However, a stepped-up investment strategy is needed in low- and middle-income countries. A review of country-specific investment requirements in sustainable infrastructure suggests that developing countries face a gross annual financing need of

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[33] Stern et al. (2021). G-7 leadership for sustainable, resilient and inclusive economic recovery and growth. London: Grantham Research Institute on Climate Change and the Environment, pg. 67.
[34] IPCC (2021). AR6 Climate Change 2021: The Physical Science Basis. Geneva: Cambridge University Press.

around 1.2 percent of GDP ($430 billion equivalent) by 2025 to transition to a green economy.[35]

3.2.2. Stepped up investments in nature, adaptation, resilience

Alongside investments in sustainable infrastructure and the green transition, the world likewise needs to step up investments to protect and restore coastal areas, wetlands, and marshes, protect biodiversity, as well as finance adaptation and mitigation efforts to help countries adapt to climate change. The G-20 has pledged support to preserve 30 percent of the earth's land and water resources by 2030. Many developing countries are home to important natural resources and natural carbon sinks and will need help to continue to maintain these global public goods. East Asia, Latin America, and Africa have the most critical sites for sustainable land use and nature preservation.

Likewise, coastal regions, small island states, countries facing more frequent droughts and floods need support to both adapt to this new climate normal and mitigate the worst impacts. These countries are at the front lines of climate change despite having contributed the least to the problem.

Another increment of 1.2 percent of GDP in spending in this area is needed in developing countries by 2025.[36]

3.2.3. Stronger human capital investments

Green, sustainable infrastructure investments are touted as a key component of a big push recovery package. Yet this cannot come at the expense of an emphasis on human capital. Human capital investments are complementary to infrastructure investments. Returns to human capital are higher than infrastructure projects, but take 15+ years to emerge, well beyond the political time horizon of many government officials.[37] This leads to an underinvestment in human capital, which hampers long-term GDP growth. An IMF study finds that the long-term gains from infrastructure are reduced with less human capital investments.[38] They suggest that the optimum share of human capital in any investment package is around 50 percent.

Human capital investments are also essential to an inclusive growth agenda. The upcoming demographic transition presents a challenge for the world. Of the 1.3 billion

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[35] Bhattacharya et al. (2021). "Financing a big investment push in emerging markets and developing countries for sustainable, resilient and inclusive recovery and growth,"*Forthcoming*.
[36] Bhattacharya et al. (2021).
[37] Buffie et al. (2020). "Debt, Investment, and Growth in Developing Countries with Segmented Labor Markets." IMF Working Paper no. 2020-102.
[38] Buffie et al. (2020).

children aged 5-15 globally in 2020, about 1 billion are in developing countries ex-China. Human capital is starting from a low baseline in many of these countries, and the growing youth population means there will be large health and education needs as a result.

3.2.4. Public investment capacity building, transparency, and accountability

A core part of any long term recovery and investment strategy is increased public investment and domestic resource mobilization. Both these have major challenges in implementation.

Sharp tax increases are unpopular—witness current demonstrations against new taxes in Colombia—so governments will make efforts to minimize changes in the tax rate over time, preferring to let growth expand the tax base and generate revenues for servicing debt. However, when social returns are pushed into the future, and not directly monetized, there may be a need for future tax increases to recoup some of the initial public sector outlay.

Much has been written on the potential for increasing tax collection in EMDEs. In the medium-term, more emphasis can be put on administrative issues rather than changes in tax rates. The IMF reports that the operational strength of tax administration agencies is positively associated with tax collection.[39] It recommends strengthening compliance risk management practices by risk profiling and auditing, and use of third-party data and digitalization of services. The IMF also notes that increased staffing of a tax administration agency can lead to improved collections.

Overall, a greater emphasis on transparency and accountability is needed alongside any efforts to scale up public investment. Citizens need to know on what government is spending money, and be able to see the outputs of greater tax collection efforts in their communities. There must be stronger civil society and legislative budget oversight through open government and budget processes. A big push investment effort without these associated reform efforts leads to risk of elite capture and bureaucratic inefficiency.

3.2.5. A fresh, longer-term, perspective on debt sustainability analyses

Investments on this scale, especially in sustainable infrastructure, will rely heavily on debt finance. Most debt sustainability assessments—whether made by credit rating

[39] Chang et al. (2020). "Raising Tax Revenues: How to get more from tax administrations?" IMF Staff Working Paper WP/20/142.

agencies or by the IMF/World Bank Debt Sustainability Assessments—review capacity and willingness to service debt over a 5 to 10-year horizon. This time frame is too short to capture many of the benefits of investments in human capital, nature preservation, or sustainable infrastructure. Therefore, in these analyses, any incremental spending adds to debt and worsens measured "debt sustainability" unless the spending is financed in a pay-as-you-go fashion. However, spending on human capital, nature, adaptation, and sustainable infrastructure is largely for the benefit of future generations and thus should be financed by long-term debt, or at least debt that can be rolled over into the long-term. Yet these microeconomic foundations are only considered in a highly simplified form in the Debt Sustainability Assessments used by the IMF and World Bank. Their method is largely based on macroeconomic variables and has been criticized for a failure to take into account linkages between public investment, borrowing and growth, and fiscal reaction functions. For example, they do not build in the damages that can result without spending on adaptation and resilience, or the indirect costs of failure to transition rapidly to a green economy. Incorporation of these features into the economic analysis would lead to far less conservative borrowing and investment strategies for most countries.

The Debt, Investment, and Growth (DIG) and Debt, Investment, Growth and Natural Resources (DIGNAR) class of models developed by staff at the IMF are an effort to bridge the gap between microeconomic project evaluation, especially for public spending, and macroeconomic outcomes. The models have been calibrated to 65 developing countries to show how a big-push investment strategy might be financed.[40] Some fundamental lessons emerge. First, sound public investments always improve long-term creditworthiness indicators like debt/GDP ratios regardless of the existing level of debt. For example, good public infrastructure projects boost GDP growth directly through adding to the public capital stock, and, because the public capital stock is complementary to private capital, this raises the rate of return to private investment, giving a further boost to growth. While the models are based on neoclassical dynamic general equilibrium, one can infer that the growth and creditworthiness impact of new public investment is even stronger when economies are in recession. Where there is a "debt overhang" that precludes voluntary market-based financing of these projects, there is a public policy issue about how to coordinate the required investment and financing.

The quantitative improvement of creditworthiness that comes about from higher public investment depends on the rate of return to public investment that in turn depends on public sector capabilities. If these are limited, or if the project pipeline is weak, there could be wastage and inefficiencies that limit the success of any big push. But by and large, the calibrations suggest that in most of the countries that have been studied,

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[40] Gurara et al. (2019). "Some Policy Lessons from Country Applications of the DIG and DIGNAR Models." IMF Working Paper no. 2019-62.

returns to public investment are sufficiently high to justify considerable additional investments. For example, the IMF's Public Investment Management Assessment ranks African countries almost as highly as Asian countries (4.4 vs. 4.5) even though the former have far lower investment levels compared to the latter.[41] It would appear that the reason for low investment rates in Africa is lack of access to finance and therefore limited project identification and development, rather than lack of investment efficiency or low returns. Therefore, building a better project pipeline, and strengthening local capacity to do this, remains a near-term priority for development institutions. Domestic development banks can play a key role in this effort.[42]

The second lesson is that the trajectories of optimal public debt to GDP tend to peak at far higher levels than is conventionally accepted as "safe," and remain elevated for long periods. This suggests that the principal risk facing a developing country government trying to implement a big-push strategy is liquidity, or roll-over, risk. If this assessment is accepted, the implication is that more attention should be paid to mitigating roll-over risk—instruments like first-loss guarantees are one example, but risk mitigation is highly underdeveloped in the international financial architecture.[43]

Another way to reduce roll-over risk is to source more development finance from official creditors who have the time horizons and the policy flexibility to manage such roll-over risk, as demonstrated in their past debt restructuring initiatives. Private creditors have fewer incentives to engage; hence the frequency and unpredictability of sudden stops of private capital.

Roll-over risks can also be mitigated by borrowing less from abroad and relying more on domestic resource mobilization (DRM), either in the form of taxation, or draw-downs of previously-established commodity buffer funds (or reserves), or reliance on local capital markets. The DIG models build in fiscal reactions that smooth tax increases over time and minimize sharp changes in tax rates.

The various simulation examples of DIG models show that DRM and external borrowing are complements rather than substitutes in big-push packages. Excessive reliance on DRM will imply large reductions in current household consumption that may not be politically feasible. At the other extreme, excessive reliance on external borrowing without any DRM measures will require large future changes in taxes to restore creditworthiness. A policy package that avoids these extremes is preferable. Modest tax increases in the short term, accompanying additional external borrowing, can finance an

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41 IMF (2018). "Public Investment Management Assessment Review and Update." IMF Policy Paper.
42 As an example, the International Finance Corporation has launched a major effort to expand the pipeline of bankable projects with encouraging early results.
43 Global Financial Governance (2018). Making the Global Financial System Work For All. Report of the G-20 Eminent Persons Group on Global Financial Governance.

investment-led growth strategy while providing signals to lenders that debt trajectories will be kept on a sustainable path in the future.

Concessional credits or grants play a similar role to DRM in terms of the impact on creditworthiness. They reduce the peak levels of external debt/GDP along an optimal big-push trajectory, and they reduce the length of time until debt/GDP ratios fall to levels that would permit reasonable access to private capital markets.

In an extension of the model to include labor market segmentation, Buffie et al. (2020) show that complementary investment in human capital forms a significant part of the big-push package—with a better-educated labor force, the return on infrastructure rises—but they caution that policymakers may choose not to invest in this fashion because economic variables of interest to policymakers, like GDP, wages and jobs, only exceed the counterfactual level after a lag of over 15 years.[44] Myopic policymakers would likely underinvest in human capital while emphasizing physical infrastructure in a big-push strategy but this would be sub-optimal.

The insights from economic theory, extracted from the models on a big-push strategy, can be summarized as follows:

- For most developing countries (but not all) returns to public spending are high enough to justify a big-push expansion. With the urgency of achieving a speedy recovery and the need to accelerate the transition to a green economy, the big-push strategy would improve creditworthiness in the long run.
- The big push should incorporate both infrastructure and human capital; the latter could require special attention from donors to counteract myopia by national policymakers.
- External financing of the big push is desirable, but, unless funded by grants, this will entail far higher levels of debt/GDP for far longer than has traditionally been seen, raising roll-over risk and exposing countries that borrow at floating interest rates to market risk.
- Multilateral financial institutions are better placed to bear and manage roll-over risk than private capital markets, and provide finance far more cheaply, giving them a special role to play.
- DRM, grants, and concessional credits can reduce peak debt levels and shorten the time period of a return to "normal" debt/GDP ratios.

If one accepts that debt levels might need to be higher for longer periods than has been the case historically, it is important to build confidence in the system for monitoring and

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[44] Buffie et al. (2020).

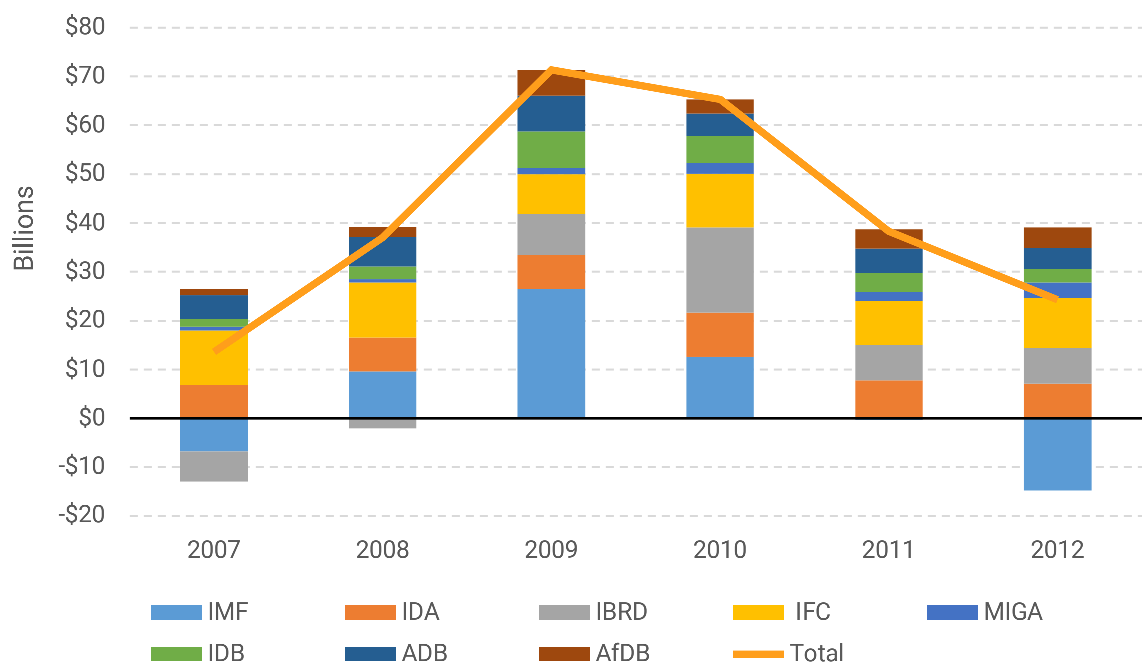
managing debt. Institutionally, a number of reforms would improve the situation: enhanced debt transparency and a comprehensive debt registry, mandatory collective action clauses in sovereign bond contracts, clarity in and enforcement of debt resolution work-outs and the role of creditor committees, burden sharing principles between official and private creditors, use of state-contingent financing instruments, and earmarking of new lending and deferred debt service on specific sustainable investments through debt-for-nature swaps and similar instruments.

4. The Big Push Investment Strategy: Who needs to do what?

Compared with the GFC of 2008-2009, developing countries will likely need more support over a longer time frame to cope with the long-term impacts of COVID-19 recovery. As Figure 5 below illustrates, the international community rapidly stepped up financing to developing countries in 2009 in response to the GFC and sustained these elevated levels through 2010. However, by 2011, net disbursements from the major MDBs had fallen back to pre-GFC levels.

This same pattern is not tenable for the current crisis. The international community should use this moment of ramped up support as a platform for a larger expansion of financing to developing countries. Expanded support is needed over the medium term to not only deal with long-term scarring from COVID-19, but to catalyze progress towards the Paris Agenda and the SDGs by 2030.

Figure 5. IFI Net Disbursements to EMDEs before and after the Global Financial Crisis



Source: World Bank quarterly financial reports, IMF financial query system, ADB annual reports, IDB annual reports, and AfDB annual reports. Totals exclude lending to high-income countries where possible.

The challenge for the development finance system is to get the right amount of funds to the right place at the right time. It is useful to differentiate between *general purpose* *finance* that is suitable for recurrent expenditures, such as health, education, agriculture, forestry and land use (AFOLU), biodiversity conservation, and climate adaptation and resilience; and *project finance* that is more suited for sustainable infrastructure investments. Project finance is typically leveraged by debt. It generates a stream of revenues that cover equity returns and the debt service associated with the project. General purpose finance can also be leveraged—sovereign bonds and local capital market borrowing are examples—but it relies on improvements in tax collections to offset future debt service. These distinctions are important for matching the right type of finance with spending. For example, the private finance portion of public-private infrastructure partnerships largely supports sustainable infrastructure, with well-specified waterfalls for how revenues will be allocated. On the other hand, private finance through sovereign bond lending can be used for either recurrent spending or project finance; servicing of these debts comes from general government revenue.

Table 2 summarizes how these principles play out in terms of what kind of financing is best suited to what kind of spending and in which countries.

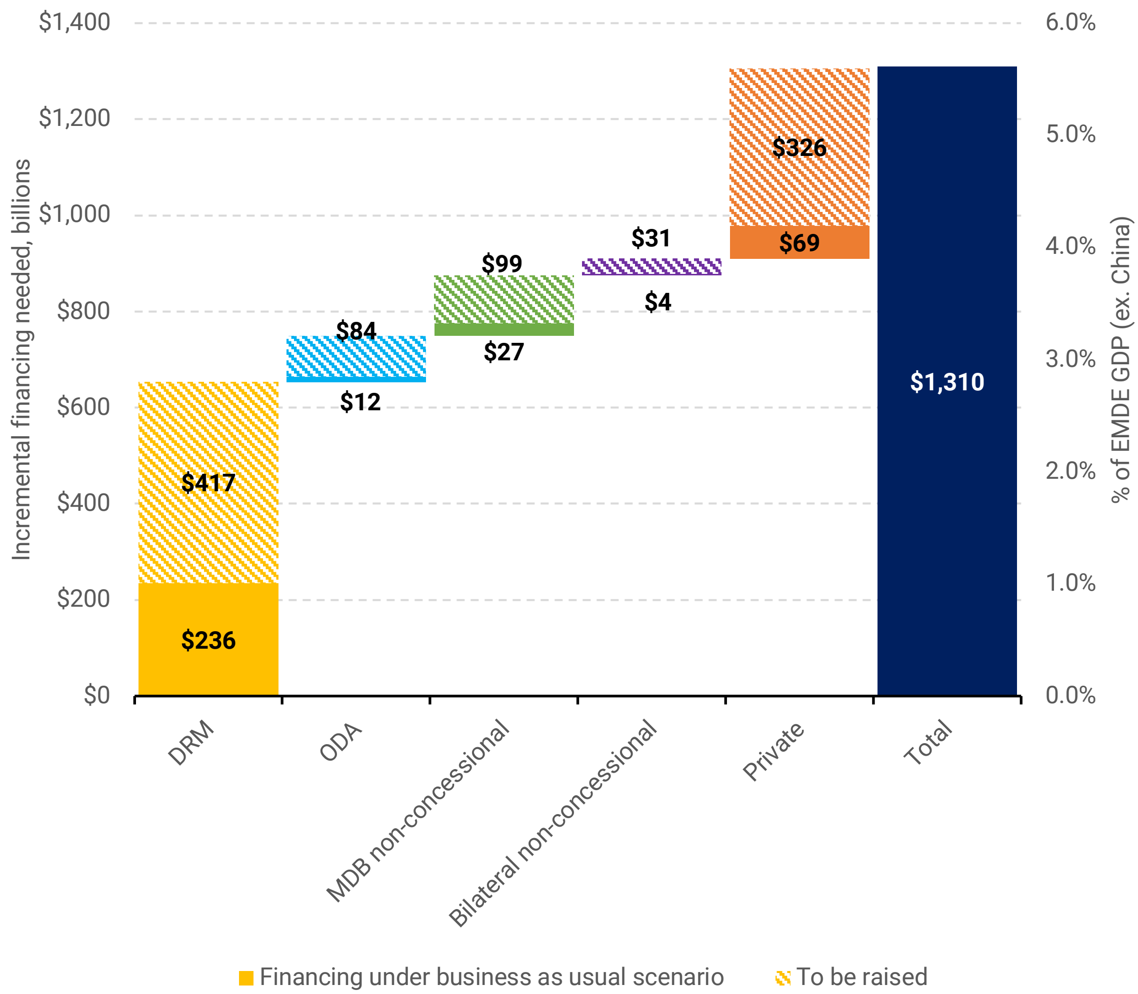
Table 2. Financing Heatmap

Denotes which type of spending is most important for which source of finance

		Official finance		
Category	**DRM**	**ODA**	**Multilateral non-concessional**	**Private finance**
Human capital	High	Medium	Medium	Low
AFOLU	Low	High	Medium	Medium
Adaptation & resilience	Low	High	Medium	Low
Infrastructure	Medium	Low	High	High
Low income	Medium	High	Low	Low
Lower middle income	Medium	Medium	High	Medium
Upper middle income	High	Low	Medium	High

A big push investment strategy is needed to catalyze the transformational agenda described above. Drawing on related work building country-by-country estimates of spending needs in key areas, we use the aggregate figure of an incremental $1.3 trillion as a benchmark for what is needed in annual investments by 2025 to make significant progress on the policy areas highlighted above: human capital, sustainable infrastructure, AFOLU, and adaptation and resilience (see Figure 6). We estimate that about $350 billion of this could be raised under business as usual financing trends. This leaves an incremental financing gap of around $1 trillion that still needs to be filled. In the following section, we lay out our approach to filling this financing gap, calling for a coordinated approach from the international system to ensure the right financing sources are used to fill the right needs.

Figure 6. Big Push Financing Strategy



Source: Authors calculations, based on methodology in Bhattacharya et al. (forthcoming)

4.1. DRM capacity building

EMDEs (ex-China) currently raise $5.3 trillion in domestic revenues for spending on the SDGs.[45] There is a tight relationship between the level of national income and the amount of taxes collected. On average, for every ten percent increase in per capita income levels, governments collect an additional 11 percent in taxes.[46] If this

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[45] IMF (2021). "World Economic Outlook – October 2021."
[46] Kharas and McArthur (2019). "Building the SDG Economy." Global Economy and Development Working Paper 131.

relationship continues to hold, EMDE governments can be expected to raise an additional $236 billion that can be devoted to the priority areas of the big push.

EMDEs could do better.[47] The median low-income developing country collects 15 percent of GDP in tax revenue (excluding social security contributions), compared to 18 percent for emerging market economies and 26 percent for advanced economies.[48] With economic growth and more equality, tax collections rise; increasing revenues by 3-7 percentage points of GDP in the medium term is "an ambitious but achievable aspiration" for many EMDEs.[49]

A key component of any tax reform effort is greater international cooperation and information sharing. The Inclusive Framework on Base Erosion and Profit Shifting (BEPS), an initiative coordinated by the OECD and G-20, aims to build global consensus around two pillars of action - where multinational corporations should be taxed, and a global minimum corporate tax to avoid profit shifting to low tax jurisdictions.[50] According to the OECD, BEPS practices cost countries $100-240 billion per year. Efforts across both pillars would increase global corporate income tax revenues by $50-80 billion per year, or 2-3 percent of global corporate income tax revenue.[51] However, the revenue gains for developing countries from these efforts will likely be quite modest. Reforms under Pillar 1 would yield an additional 0.5 percent of corporate income tax revenue to middle-income and low-income countries.[52] Reforms under Pillar 2 would yield an additional 0.75 percent of corporate income tax revenue for middle-income countries and 1.25 percent to low-income countries. The minimum corporate tax rate recently agreed to by 136 countries, 15 percent, is well below what many developing countries would prefer, and excess profits would still accrue to the country where a corporation's sales are, leading to greater collection in richer countries.[53]

Another initiative from which developing countries stand to benefit is the Global Forum on Transparency and Exchange of Information for Tax Purposes. This provides for enhanced cooperation between tax authorities in different countries and would allow

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[47] Fenocchietto and Pessino (2013). "Understanding Countries' Tax Effort." IMF Working Paper no. 13/244.
[48] Gasper et al. (2019). "Fiscal Policy and Development: Human, Social and Physical Investments for the SDGs." IMF Staff Discussion Notes no. 19/03.
[49] Benedek et al. (2021) "A post-pandemic assessment of the sustainable development goals," IMF Staff Discussion Note No. SDN/2021/003
[50] OECD (2020). "International community reviews commitment to address tax challenges from digitalisation of the economy." December 10.
[51] OECD (2020). Tax Challenges Arising from Digitalisation - Economic Impact Assessment: Inclusive Framework on BEPS. OECD/G-20 Base Erosion and Profit Shifting Project. Paris: OECD Publishing.
[52] OECD (2020). Tax Challenges Arising from Digitalisation, Figure 1.1, pg. 18.
[53] Thomas (2021). "Nations agree to 15% minimum corporate tax rate." BBC, October 8.

developing countries to better capture tax revenue from money shifted abroad by their nationals.[54]

Work is also underway to help stem illicit financial flows, including tax evasion, corruption, and illegal activities. Size estimates vary, and none are very precise; however, the size of these flows is likely large, and hence a potential source of greater revenue capture. Illicit flows not only hurt revenue collection efforts, but erode institutions, and make government spending less effective. There have been some global efforts to date to stem these flows; the World Bank/UNODC Stolen Asset Recovery Initiative (StAR) has returned to countries $8.2 billion to date, and the Extractive Industries Transparency Initiative (EITI) has disclosed $2.7 trillion in revenues to ensure the profits from natural resource extraction benefit the public. However, these efforts are quite small in comparison to the potential size of flows.

Our approach calls for an incremental $653 billion from DRM, equivalent to 2.7 percent of developing country (excluding China) GDP. This accounts for 50 percent of our financing packaging, ensuring developing countries have an equal stake in the big push strategy.

4.2. Multilateral Development Banks—greater ambition

The MDBs are uniquely placed to contribute to an agenda of a "big investment push." They are the lowest cost source of development finance and enjoy informal preferred creditor treatment. They can offer lower interest and longer maturities than other lenders and can combine loans with grants, technical assistance, and policy and institutional guidance. They represent the most sustainable, scalable way for developing countries to finance needed public investments, but demand for their finance is sometimes low because of cumbersome administrative and technical processes involved—in-depth project assessments, environmental and social safeguards, and strict financial management practices. These often take time to implement, so some governments choose to pay the higher costs of borrowing from private capital markets to access money faster and with fewer restrictions on use.

On the supply side, MDBs have also faced prudential constraints of single borrower limits, callable capital accounting, debt/equity gearing, and the like. The combination of supply and demand constraints has resulted in a steady diminution of their role over time; they currently represent 8.5 percent of developing country total external debt.

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[54] OECD (2021). "International tax standards." Global Forum on Transparency and Exchange of Information for Tax Purposes.

There is much the MDBs can do to expand lending now under their current balance sheets, but the preferred course of action is for shareholders to provide additional equity over time. By making greater use of callable capital and reforming statutory lending limits, the MDBs could lend out an additional $750 billion while still maintaining their AAA rating.[55] If they were willing to risk a ratings downgrade to AA+, they could expand lending even further to $1.3 trillion. There are other proposals on the table, including balance sheet optimization, greater risk pooling, and turning over capital faster. The MDBs could do a better job of catalyzing private investment through the use of guarantee facilities, creating platforms for blended finance in specific sectors, and scaling up asset sales programs to allow private investors to purchase mature assets. [56] The MDBs also have a clear role to play in de-risking investment projects for the private sector, both during the construction and operational phases. Partnerships with large institutional investors through the use of instruments like the International Finance Corporation's (IFC) Managed Co-Lending Portfolio Program (MCPP) can mobilize private capital.

Our approach calls for the MDBs to triple their 2019 lending levels for an incremental $126 billion by 2025. We also call for a doubling of bilateral non-concessional financing for an incremental $35 billion.

4.3. Concessional finance

Aid has held steady over the past year, and even increased slightly in 2020, according to preliminary OECD figures. However, if countries were to reach the long-standing 0.7 percent of GNI target for aid, the DAC countries alone would have mobilized $352 billion in 2020, or $191 billion more than what was actually disbursed. ODA is the best source of finance for many pressing problems, such as helping poor countries implement mass vaccination programs, helping them mitigate and adapt to climate change, investing in nature, and building a pandemic preparedness system among other global priorities. These programs have very high returns for donor countries as well as for recipients, so the case for aid has never been stronger.

There are good prospects for stepping up aid channeled through IDA. The decision to complete IDA20 negotiations one year ahead of schedule promises to unlock significant new flows, permitting a program of action of about 10 percent more in nominal terms — about an incremental $8 billion— compared to the original program for IDA19. Ultimately, higher levels of aid must come from national budgets which are under pressure in many advanced economies. The U.K. has already announced a planned cut in its aid budget.
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[55] Humphrey (2020). "All hands on deck." ODI Briefing Paper.
[56] Bhattacharya et al. (2018). "The new global agenda and the future of the multilateral development bank system." Brookings, CGD, and ODI.

The European Union's multi-year framework budget is lower than before and more oriented towards the EU neighborhood.[57] President Biden has proposed a $4.4 billion increase in US aid in his 2022 budget submission to Congress, mostly oriented to more health spending and contributions to international funds. A new collective agreement is needed to raise aid from all the major donors.

Already, there are pledges to double ODA for climate finance from $30 to $60 billion. But ODA is also needed for a mounting suite of development priorities and global public goods: climate, biodiversity, adaptation and resilience, pandemic surveillance, food security, humanitarian response, nature preservation, human capital, de-risking private investment in sustainable infrastructure, and for additional equity for the MDBs, to give a few examples. The issue is whether the current level of concessional financing, welcome as it is, will provide enough resources to permit the needed expansion across all these domains while also meeting existing priorities. Reaffirmation of the commitment to increase aid, including climate finance, towards 0.7 percent would provide a solid core for an expanded international development finance system.

Our approach calls for a 50 percent increase in ODA relative to 2019 levels, an incremental $96 billion. This is equivalent to 0.15 percent of donor, excluding China, GDP.

There is also scope to tap into the growing flows of private philanthropy going to developing countries. In 2018, cross-border private philanthropy from all sources was about $70 billion, $48 billion of which came from the U.S.[58] Large foundations have a history of leaning in on health and education public goods, and this could extend to climate finance. Philanthropists could contribute to a new Climate Finance Facility and leverage their funds in the way put forward by the International Financing Facility for Education (IFFEd).

These forms of innovative financing should be thought of as additional to, not substitutes, for ODA. Philanthropy can work alongside ODA, helping fund global public goods and focus international attention on growing issues. But neither of these financing streams can substitute for either the volume or breadth of ODA.

4.4. Private capital mobilization

Private finance rapidly exited developing countries at the start of the pandemic. FDI fell by 35 percent in 2020, and though it will recover some this year, it is still projected to

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[57] Foresti (2020). "What the EU recovery fund means for Europe and international development." ODI Blog, July 23
[58] Indiana University Lilly Family School of Philanthropy (2020). Global Philanthropy Tracker 2020. Indianapolis: Indiana University.

remain 25 percent below 2019 levels.[59] Greenfield investment project announcements were down by 42 percent in developing countries in 2020, and equity investments flows fell by 50 percent.

While there is scope to scale up public finance for sustainable investment by boosting and better managing fiscal space and MDB balance sheets, ultimately the required levels of investment far exceed public sector capacity. Private investment and finance willing to bear commercial risk must step up and help to fill the gap. However, there is no functioning market for low- and middle-income country infrastructure assets, and there are significant regulatory headwinds. The rules to safeguard the financial sector put in place after the GFC of 2008-2009 have had the side-effect of altering capital allocation decisions. Compliance with Basel III and Solvency 2 means that *long-term* lending for *infrastructure* projects in *developing countries*—a triple whammy of risk flags—must be backed by large charges against the capital of a financial institution, causing project financing by banks and insurance companies to wither after 2007.[60]

There are big challenges both on the supply and the demand side of project finance: a lack of 'bankable' projects, especially in countries with low state and private capacity; and the limited presence of long-term institutional investors who are being held back by risk, information and liquidity concerns.

Any strategy to scale up finance for sustainable investments must include both elements: a concerted, large-scale support for the development of project pipelines and new arrangements to encourage the participation of long-term institutional investors. There is an important role for MDBs, bilateral assistance programs, and multilateral platforms such as the Global Infrastructure Facility (GIF) and Public-Private Infrastructure Advisory Facility (PPIAF), in helping to create the conditions 'upstream' that will allow projects to emerge downstream—by supporting policies and regulations (e.g., frameworks for renewable independent power producers (IPPs)) that enable private investment, building institutional capacity and providing hands-on advisory and technical assistance for project feasibility and preparation. Without significant growth in the pipeline of bankable projects, sustainable infrastructure, and climate finance mobilization efforts will simply end up competing for scarce project finance. It can be done; IFC's Upstream project has already more than tripled its pipeline in a single year.

The MDBs also have substantial experience with de-risking private capital in the context of investment projects, during the construction and operational phases, or providing "stamps of approval" by co-financing. IFC, for example, accounts for just under one-half

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59 UNCTAD (2021).

60 Beck and Rojas-Suarez (2019). Marking Basel III Work for Emerging Markets and Developing Economies: A CGD Task Force Report. Washington, DC: Center for Global Development.

of all private capital mobilization by official bilateral and multilateral development agencies combined. Others could learn from their experience. Total long-term private and institutional capital mobilized by the MDBs and bilateral Development Finance Institutions (DFIs) for low- and middle-income countries was US$63.6 billion in 2019. Of this amount, 32 percent was direct mobilization and 68 percent was indirect; US$6.7 billion was mobilized in low-income countries. There is scope for mobilized capital to play a far larger role in infrastructure financing, in particular.[61]

Our approach calls for an approximate doubling of private lending between 2019 and 2025, for an incremental $395 billion.

4.5. International financial architecture

In addition to stepped up efforts by individual actors, there is a need for greater coordination across the development finance system to scale up financing. When there is international consensus on the broad approach, it is easier for finance ministers to approve programs of greater spending (under the right conditions and supervision), for donors to demonstrate the returns from provision of global public goods, for the MDBs to get authorization for stepped up ambition and for the private sector to gain confidence in the system. There is, however, no formal system governing the international financial architecture. Instead, different institutional arrangements connect various pieces to each other. Strengthening the system is therefore not just a matter of adding more finance, but also of building the linkages so that the right finance is available for the right projects at the right time.

There are many ongoing discussions and ideas for strengthening parts of the system, but less has been done on forging a consensus approach so that all parts of the system act in a linked-up fashion through shared indicative plans and strategies, a pre-requisite for effectiveness in a system that does not have a mechanism for common, collective action.[62] This is not some call for a global central plan where all actors cooperate with each other, in the sense that they pool resources, knowledge and planning and implementation activities. Coordination can be done on a smaller scale through individual country platforms. Instead, it is a call for international oversight of core recovery programs, the building of consensus around which individual actors can orient their actions, and the inclusion of regional partners to augment the voice of developing countries. Transparency is a crucial part of any financial architecture. The true extent of

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[61] MDBs and DFIs (2021). MDB Report on Mobilization of Private Finance. Washington, DC: World Bank Group. Direct mobilization is due to “active mobilization” by the DFI, evidenced e.g. by a contractual relationship, while indirect mobilization represents other sources of finance for the project including sponsor funds.
[62] Woods (2011). “Rethinking Aid Coordination.” In H. Kharas et al. (eds.). Catalyzing Development. Washington, DC: Brookings Press.

a country's debt burden is often not revealed until a debt restructuring process is underway. There must be a process for reconciliation between creditor and debtor country ledgers, as well as a process to "enhance the sharing of detailed sovereign debt information, with provisions for the confidentiality of commercially sensitive information. Debtors and creditors should include information about collateralized debt (and other long-term sale or resource-backed arrangements amounting to collateralized debt), and debt to state owned enterprises and sub-national governments backed, de jure or de facto, by the sovereign."[63]

Debt renegotiation can be made more predictable and orderly when private creditors can organize themselves to achieve efficient and equitable outcomes. Bondholders are increasingly using collective action clauses, but the range of bespoke private lending arrangements makes it difficult to extend this across all creditors.

The Common Framework marks a step forward in greater international cooperation around debt workouts, but it is incomplete. While progress was made bringing both Paris Club and non-Paris Club creditors into the agreement, more regular discussion is needed to adapt norms and standards to the proliferation of creditor interests in a legitimate and equitable way.

Credit ratings agencies (CRAs) play a major role in the international debt architecture. CRAs provide ratings based on short-term market conditions and growth projections. Yet some argue that the CRAs should also publish long-term ratings to account for risks like climate change and benefits from long-term sustainable capital investments. Once a country defaults, there could also be more clarity around a time frame until ratings are reviewed. Countries, for example, that seek debt relief under the Common Framework risk a downgrade, but in taking this step, they are demonstrating a willingness to get their macroeconomic fundamentals in order. More broadly, credit rating agencies could consider how to communicate their views on a country so as to avoid procyclical impacts of ratings downgrades that could exacerbate the very debt crises they would like to avoid.[64] One option is to consider some form of public ratings agency that would oversee the CRAs, providing some level of transparency, accountability, and competition with the big three agencies (S&P, Moody's, and Fitch). However, how this would be organized, and who would oversee such a body, remains an open and contentious question.

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[63] Friedrich Ebert Stiftung and Consensus Building Institute (2021). Roundtable report: Responding to Risks of COVID debt distress. Berlin: Friedrich Ebert Stiftung.

[64] Li (2021). "Debt relief, debt crisis prevention and human rights: the role of credit ratings agencies." Report of the Independent Expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights. A/HRC/46/29.

5. Conclusion

As the second year after the start of the COVID-19 pandemic draws to a close, the stresses in the global economy and the extent of global solidarity have become more visible.

The broadest and deepest global economic recession in history took place in 2020 but was followed by rapid recovery in most countries. Some economic scars will be long-lasting and 31 developing countries may not return to 2019 real income levels by 2025. Extreme poverty rose rapidly but is now on the decline and set to return to its pre-pandemic trend, albeit at a level with around 50 million more poor people than what was expected before the pandemic.

A handful of countries have defaulted on their debts but fears of a systemic debt crisis have receded. Rapid response by the international community—mostly new lending from IFIs but also some debt relief—has staved off an immediate crisis. This liquidity opened modest fiscal space and provided foreign exchange that could also be used to pay commercial debt service. A new issuance of SDRs has injected additional liquidity into the system.

The response so far has bought some time in averting crisis but leaves the root causes of structural problems unaddressed. In the next five years, developing countries owe $1.5 trillion in debt service; many middle-income countries still have a substantial risk of not meeting these obligations. Middle-income countries also account for the majority of the group of 41 hardest-hit countries that are forecast to have lower per capita GDP levels in 2025 than in 2019.

In the longer term, there is a considerable danger that the "build back better" agenda will remain an empty slogan in developing countries. There is no consensus on burden-sharing to promote transitions to net zero, fast-growing, nature-preserving, inclusive economies. The risk is that a business-as-usual approach will usher in a period of stagnation and austerity in many developing countries that in turn will worsen the creditworthiness of these countries.

These big problems require greater ambition and financing than has been proposed to date. As U.N. Special Envoy for Climate Action and Finance Mark Carney recently said, "A rule of thumb for climate finance is to concentrate on initiatives that have the prospect of catalyzing at least $50-$100 billion per year in investment to EMDEs for decades. We won't get to net zero in a niche."[65] The time is ripe for expanded scope and ambition, using the catalyzation of COVID-19 resources as a springboard for stepped up investment on a slate of global recovery and build back better priorities. We estimate that such an agenda would require additional public spending of $1.3 trillion in developing countries ex-China.

Such a big push on public spending requires an associated big-push financing structure that will fund transition spending for a decade or two. The current measures have bought time to put such a structure in place, but significant progress on three fronts is needed.

First, consensus is needed on the idea that a large, integrated investment big-push in low- and middle-income developing countries is desirable and feasible, notwithstanding the current significantly indebted status of many countries. Such a big push should encompass human capital, sustainable infrastructure, agriculture, and land use, and adaptation and resilience together. These investments are complementary and overlapping, yet are often considered separately by advocates—climate mitigation, nature conservation, pandemic surveillance, education, and adaptation have each had major global reports extolling their individual benefits, but without recognition of the spillovers that investing in one area has on the other.

A big-push program averaging 3.8 percent of GDP in developing countries would put countries on a path towards sustainable and inclusive growth and recovery. The size and composition will vary considerably with country circumstance, but the approach of a coordinated expansion would bring large benefits to all economies and would help provide global public goods, whose absence is the Achilles Heel of the current world economic system.

Second, there is a need to build a financing package to support such an investment big-push. Each component of financing—domestic resources, concessional finance, MDBs, and private capital—has its own role. Domestic resources are the main component, both because they are the cornerstone for creditworthiness and because many of the public investments needed are on-budget, with high economic and social returns but limited financial returns. Human capital investments and nature conservation mostly fall into this category. Developing countries can do more to raise tax collection to fund inclusive growth but could benefit from additional capacity building support. International assistance to build stronger tax administrations, coupled with a voice on global rules of the game, such as on equitable multinational profit sharing, offer promise. Efforts to

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[65] M. Carney. 2021. "The Price of (Net) Zero Ambition." Speech at Colombia University, Sept. 23.

stem illicit financial flows are also needed. Steps on both are being taken but are not adequate to the task at hand.

More aid is also needed. ODA is simply too small for the growing tasks at hand—concessional finance for climate mitigation and adaptation, biodiversity preservation, pandemic surveillance, and vaccinations have been overlaid on historical aid programs aimed at poverty reduction, human capital, infrastructure, and humanitarian assistance. Aid supplements domestic resources, especially in low-income countries. But it does far more. It must now become the core of global public goods provision, including financing the platforms and partnerships that are needed for project identification, standardization of processes, de-risking of project finance and the like. In short, the quality of aid must rise along with its volume. In doing so, traditional mechanisms for allocating aid—by country per capita income level or sector—will become outdated as they are not consistent with the new demands of global public goods provision.

In 2020, the year of the pandemic, ODA from DAC countries rose by 3.6 percent in real terms, an incremental $6 billion in a year, when the same countries spent an incremental $12 trillion to revive their own economies and strengthen domestic safety nets. Aid will not rise from current levels without a new compact to deliver higher amounts. The commitments made to double aid for climate finance are a good start, but there is a risk that this will not be additional to existing ODA commitments. Parallel commitments on the total volume of aid are needed, commensurate with the issues in front of us. A recommitment of DAC countries to move towards the 0.7 percent ODA target, coupled with an intermediate target of raising aid to 0.5 percent of GNI by 2025, would be an important pledge by DAC donors towards a big-push financing package.

Aid can be leveraged. When it is channeled through multilateral funds and banks, the equity embedded in aid can be multiplied. Funds like IDA are already doing this by issuing bonds in international capital markets. Aid can be leveraged even more by channeling it through multilateral banks, either in the form of equity or in the form of guarantees for mobilized private capital. The large MDBs have expanded lending in a countercyclical way in response to COVID. This has helped their clients in the short run, but a return to the sustainable lending levels previously approved by their Boards would hurt medium term growth prospects in EMDEs. A big push on development is inconceivable without the MDBs playing a far larger role. Their shareholders need to project a vision of these institutions' contribution to global public goods and development spending over the next decade.

With the right approaches, private finance can be mobilized for transformational investments. There are many technical challenges to overcome—policies and regulations, lack of bankable projects, and few instruments and platforms to scale institutional capital. These can be overcome if tackled in a concerted fashion. Country platforms can provide localized governance platforms to coordinate actions. Private capital needs a vehicle to invest in at scale as well as a commitment that programs are being supported by official financial institutions.

The third component of an action plan is to create an enabling environment and strengthen the capacity to execute. Many of the building blocks are in place. For example, there are hundreds of project preparation funds, a Global Infrastructure Facility, commitments made by institutional investors and examples of scaled approaches in individual countries and sectors (for example, solar power in Egypt). What is lacking is a systematic approach to connect and integrate the various elements.

The choice being presented to many developing countries under a business-as-usual scenario is to stagnate or default. In this scenario, global public goods will not be delivered and claims of an equitable transition will be hollow. There is an alternative pathway to grow in a sustainable and inclusive way out of their current debt predicament. This is the pathway towards which political leaders must point.