A bridge to climate action

A tripartite deal for times of illiquidity

Ishac Diwan
Martin Kessler
Vera Songwe

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Executive Summary

Vital investment to re-ignite growth and progress on climate action in developing economies will fail if the current debt overhang remains unaddressed. While the international community is preparing to move from billions to trillions, efforts to translate these investments into the green transition will remain vain as long as developing countries continue to struggle with debt crises. Indeed, much of the new flows would leak out as debt service, whilst economies in disarray will be unable to increase their investments in a sustainable future. A bridge between the current crisis and a time when efforts can go in earnest to save the planet is urgently needed.

Insolvent countries need debt reduction, a difficult process under the G20's "Common Framework", and one that crucially needs to be further improved. However, most countries that are currently facing financial stress are in fact suffering from illiquidity, rather than insolvency. This situation is due to the coincidence of a rise in global interest rates at a time when bonds are maturing and the amortization of bilateral loans has risen. For these countries, coordinating debt rescheduling among their diverse creditors is essential. Pre-emptive concerted rescheduling of debt would allow illiquid countries to bridge the gap, and to start investing additional international support in the green transition while at the same time improving their prospect of servicing external debts.

This paper proposes a "bridging program" that unlocks net positive flows for countries facing liquidity constraints. The program operationalizes a tripartite deal: Multilateral development banks (MDBs) would increase their financing for new investments, including those linked to climate objectives; creditors would agree to reschedule their claims in the future; and countries would commit to stabilize their economy and engage in efforts to promote recovery.

Those three blocks are tightly interlinked. Countries would not participate in a program unless it improves their welfare. If MDBs were to step up their funding, as they are already planning to do under the optimisation of their balance sheets, it would leak out to other creditors without the program. Rescheduling is therefore essential. At the same time, existing creditors would only agree to reschedule if the debtors' ability to repay does not deteriorate over time. This means that countries need to place themselves on a renewed growth trajectory, with the support of new investments and positive net inflows.

Taken together, a standardized framework could be established to implement such deals. It would provide parties with incentives to participate and build trust progressively. The framework requires limited financial efforts compared to alternatives. For countries, it builds on existing growth plans. For MDBs, additional funding needs for such a proposal are limited: they amount to an acceleration on existing plans of expansion. Other creditors will require strong enough incentives – both carrots and sticks – to participate, but both could be mobilized if a broad political agreement could emerge. Importantly, this note only puts forward some option and opens avenues for concertation to define those incentives.

The proposal requires dedicated logistical and financial coordination. Ultimately, illiquidity is a crisis of coordination and expectations: a country is able to repay its loans if they were spread through time, but investors' negative expectations ultimately force it into default. The aim is to facilitate collective action among debtors and diverse creditors. International financial

institutions (IFIs) have evolved in recent years, preparing to scale up their funding, improve coordination among themselves, and expand their timetables to longer horizons. This proposal capitalizes on these reforms to deal more effectively with debt roll-over risks.

Such a program could start immediately for some countries, demonstrating rapid progress on a narrative of growth and climate action. This can start to turn around the overly pessimistic mood that have taken over the developing world, improving the momentum on both development efforts and the rise in environmental activism. The program is inspired by President Ruto's proposal at the "New Global Financing Pact" summit in Paris and on which he expanded in a co-authored op-ed with leaders of regional institutions. It could be seen as an enhanced Debt Service Suspension Initiative (DSSI), building on the successes of the DSSI and learning from its failures, or as a complement to the Common Framework, a second window dedicated to countries needing rescheduling but no deep debt treatments.[1]

[1] We thank Dani Rodrik who has been essential in formulating the initial arguments in this note, and the participants of the seminar co-organised by FDL and the Institute for Policy Dialogue, in Paris on October 16th, 2023 with Joe Stiglitz and Martin Guzman, which allowed to test some of these ideas. We are immensely grateful for the valuable inputs from many commenters: Adil Ababou, Masood Ahmed, Reza Baqir, Amer Bisat, Lawrence Chandy, Hamouda Chekir, Simon Cueva, Marcello Estevao, Kevin Gallagher, Hafez Ghanem, Indermit Gill, Jeff Hall, Homi Kharas, Thabi Leoka, Théo Maret, Mahmoud Mohieldin, David Ndii, Brian Pinto, Daouda Sembene, Jolie Schwarz, Brad Setser and Shari Spiegel. While we do not implicate them in the result, their advice improved the paper considerably. Feedback collected in a UN DESA workshop was important in the last stage of this project.

Introduction

There is a sharp contrast between the aspirations to scale up development finance from billions to trillions to save the planet, and the harsh financial tensions experienced by low-and-lower-middle income countries. The financing difficulties stem from the series of negative shocks they experienced since 2019, which have reversed two decades of fast growth and convergence. By 2023, rising global interest rates and reduced access to capital markets have started to make it much more expensive to service and roll-over external debt, exacerbating these pressure, and forcing devaluations and fiscal tightening. Key public spending are being slashed, pushing back Sustainable Development Goals (SDGs) gains by years, lowering growth, and making it more difficult to adress the existential challenges of the green transition (Ahmed, 2023).

To bridge the gap between a difficult reality and ambitious aspirations, public action is urgently needed. Climate action requires considerable and rapid investments in Low and Lower-middle income countries (L&LMICs). The global community has initiated a plan to increase development assistance, starting with a scaling up of Multilateral Development Banks (MDB) funding, but high external debt service is reducing aid effectiveness. Recent data (World Bank 2023) reveals that total net transfers on long-term debt to L&LMICs have become negative, for the first time in two decades. In effect, the current surge of MDBs disbursement is being more than offset by even larger negative transfers on loans to private and to non-Paris club bilateral creditors. As a result, the post-covid-19 recovery has remained modest in a context of falling domestic investment. Between 2019 and 2022, investment in L&LMICs affected by the debt crisis have fallen precipitously, while investment rates have remained constant for countries with no identified debt difficulties. On both fronts, total net transfers, and investment, the 2023 performance is likely to have worsened further.

Yet, growing investments and the reduction of climate risks should benefit developing countries *and* their creditors. It requires engineering net positive flows at scale, and thus improved coordination among the three main parties involved: countries, IFIs and other existing (bilateral and private) creditors. The debtor country stabilizes its economy and invests in new growth opportunities. MDBs lend resources that make this possible - but they can only do so productively if old creditors refrain from demanding immediate repayment and engage in debt rescheduling as needed. The old creditors, in turn, are willing to make a financial sacrifice only if they believe that this would improve their future payoffs – this requires that the MDBs ensure that their financing goes into productive investment and growth picks up (Baqir, Diwan, and Rodrik 2023).

There is much more need to focus on debt rescheduling than is currently the case. Unlike early fears in 2019-2020, the wave of defaults that many expected did not occur. The alternative diagostic is that most countries face a different type of challenge: relatively low external debt stock, but high debt service due in the next 2-3 years in the context of expensive new financing resources and a restricted access to capital markets (Albinet et al 2023). Those countries are *illiquid*, not *insolvent*. The inability of debtors to refinance maturities coming due seems largely related to the fear, among heterogeneous creditors, that their effort will leak to other creditors,

instead of easing the debtor's situation. Illiquid countries are in need of a concerted debt rollover, not of debt reduction.

Currently, IFIs are responding to liquidity tensions by expanding financial safety nets and paying back existing creditors. This is not a sustainable strategy, given that redemptions will increase in 2024 and 2025 and that official finance is limited. This expansion would be better used to fund essential new investments in developing countries. It is also politically untenable that MDBs scale up their support if it continues to leak out through massive net transfers to bilateral and private creditors.

What is needed instead is a new program that can serve as a bridge to climate action. Such a program would alleviate the short-term pressures of illiquidity, while directing new financing towards the greening of growth – in addition to other longer-term goals in health, education or social protection. This framework will also help them regain market access in the near future, when financial conditions improve. Private finance and investment will be essential for future progress.

Easing illiquidity is very much about improving collective action and it requires a well organized concerted mechanism. Like the Debt Service Suspension Initiative (DSSI) and the Common Framework, the "bridge program" requires a great level of coordination among many different types of actors: bilateral creditors, private lenders, multilateral institutions and borrowing countries themselves. The G20 is the only venue where such political consensus can be mustered. This would be akin to an "enhanced DSSI": the goal is also to reprofile debt service, but it also builds-in additional incentives to encourage private creditor participation, and widens the extension window to focus on long-term growth.

This note describes the specific purposes and tools of such a program. It is not a blueprint but should be viewed as an open proposal with a range of options that policymakers can pick from. It is organised in three parts, each with two sections. The first part makes the case for solving the liquidity crisis, describing its main features and providing an economic rationale for addressing it. The second part shows that at least 20 countries could benefit of such a program, and that new financing needs mobilised from MDBs would be limited compared to alternatives. The third part proposes to remove the hurdles that have hampered the efficacy of the original DSSI, by scaling up MDB support and incentivizing private sector participation.

1. A bridge for climate action

Adopted in November 2020, the G20's Common Framework (CF) has offered insolvent countries a process to negotiate debt relief in a multilateral setting. However, despite some successes, the process has been extremely slow, in large part because of the need to coordinate between very different creditors and associated variations in their institutional and political ability to accept reductions in the face value of debt. There have been numerous proposals to improve it[2], which are important, but the clear perception is that it is only worth considering when countries have no other choice.

This proposal targets a different set of country, which face a roll-over problem: a challenge to afford large redemptions coming due between 2024 and 2026. This is the case of at least 25 developing countries in our estimates. Of these, we are mainly interested here in 21 Low-and lower-middle-income countries (L&LMICs), of which 17 are recipient of IDA support - where debt service is above prudential thresholds defined by the IMF and the World Bank.[3] With closed markets and reduced bilateral flows, L&LMICs face years of negative net transfers, which is hurting their growth prospects and their ability to tackle the climate challenge. This double bind of rising negative net transfers and declining growth performance can eventually lead to insolvency, delaying the green transition even further. This section describes the main elements to address this crisis and ensure significant positive net transfers.

1.1 A three-legged deal: rescheduling, new financing, reforming.

The aim of the proposed "bridging program" is to attract illiquid but solvent LMICs into a new compact with the international community. It would allow them to navigate the current financial environment while stabilizing their position by avoiding large negative net flows in the next years, finding a new recovery path, and re-entering capital markets within a few years.

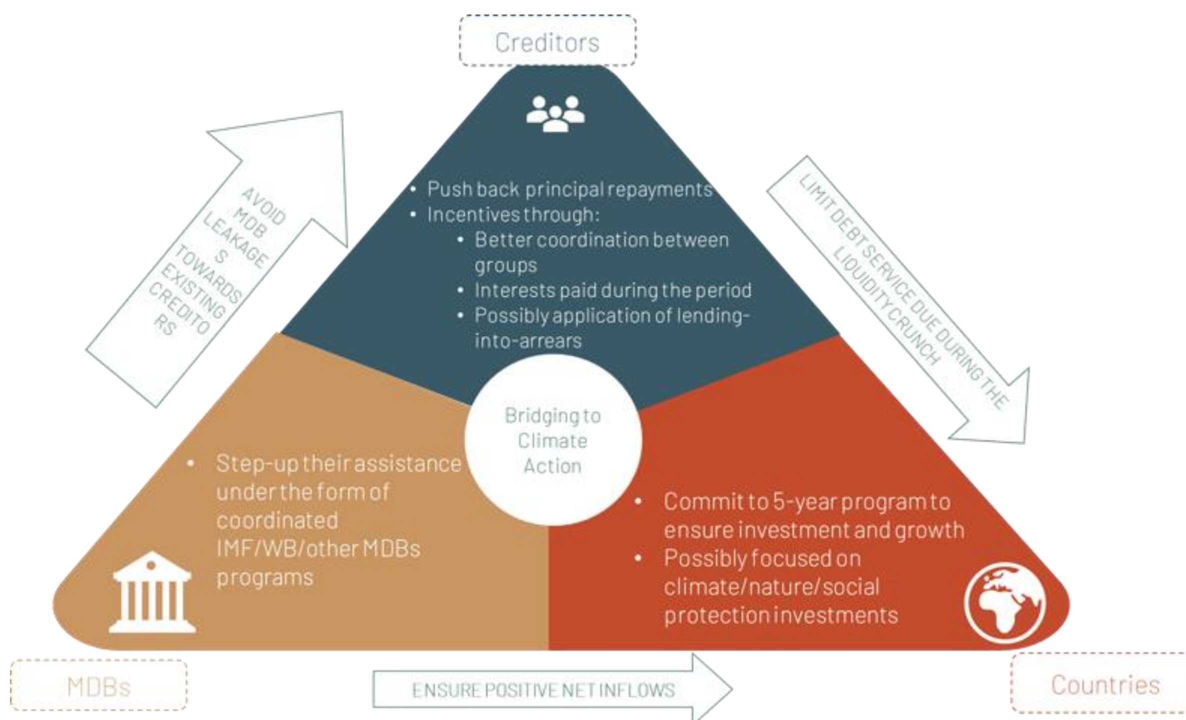
Participation in this framework would be voluntary and include three main conditions: (i) an agreement to develop a country-led 5 years national recovery program, to be supported by the World Bank and the IMF; (ii) debt service above illiquidity thresholds, but external debt that is sustainable if it was rescheduled at reasonable terms; and (iii) a willingness to negotiate in good faith a rescheduling with bilateral and commercial creditors that limits negative net transfers during the program period. An essential additional step would be to improve debt transparency to avoid mistrust from creditors that others are paid while they extend their loans.

Eligible countries would enter into a three-pillar program (Figure 1): new financing, reforming, and rescheduling. New financing would provide an additional injection of liquidity to support a recovery of investment supported by a joint IMF/World Bank program.[4] Reforming would ensure that the national recovery program contains the commitments needed to ensure that additional liquidity is well invested, and promotes growth. Rescheduling will push back obligations due

[2] See references in the bibliography for papers containing important proposals.
[3] Albinet, Kessler and Brancher (2023) is a descriptive companion paper, which provides some of the numbers for this proposal. A similar diagnostic based on different sources is in Chuku et al. (2023).
[4] A large share of the countries which could be candidates for such a treatment are already under IMF program, so it would be more about extending existing programs than adopting new ones.

during the program period to a later maturity to ensure that the new flows do not leak out of the country. The goal of the participating countries would be to rapidly re-emerge on a green growth path, with external debt payments coming due after the program period stabilized on a sustainable basis.

Figure 1: Bridging to climate action



Source: Authors.

The rules governing such a program would need to fit political constraints best addressed by the G20. There is a moral hazard risk in offering such a tool. Distinguishing sovereign illiquidity from insolvency is difficult. Some insolvent countries may pretend to be only illiquid to benefit from the program. A second moral hazard risk stems from countries in good financial health but which would still see benefits in applying – although there will be a natural tendency to refrain from risking to jeopardize their credit ratings. To reduce both risks, rules with quantitative criterions, along with a judgment of international financial institutions (IFIs) will have to determine eligibility, and apply as automatically as possible. There are also important free-riding incentives, with individual creditors wishing that others participate in refinancing while they stand on the sideline. These incentives need to be neutralized by encouraging a concerted rescheduling by all creditors.

The proposed program is predicated on the expectation of a global recovery in the medium run. The current consensus outlook suggests that the ongoing downturn will not last long more than 2-3 years, and that interest rates are close to their highest point and will soon stabilize and start falling. In this view, supporting LMICs to pass the current bump in the road will end up saving the world a costly systemic crisis down the road.

1.2. Making the case for debt rescheduling

Insolvency of a country refers to a situation where policies that could help it repay its debt are not economically or politically feasible. Such policies may include measures like exchange rate depreciation, fiscal austerity, etc. When a country realizes that it is better off reneging on its obligations rather than pursuing such self-defeating policies, it may choose to default. On the other hand, illiquidity relates to a different situation, where debt service is high and vulnerable to an inability to roll over debt, even though the country is solvent. This is occurring currently, due to the coincidence of rising global interest rates, high amortizations due to Chinese (and other bilateral) creditors and repayment walls on Eurobonds. A country would be able to bear its debt obligations, if they were smoothed over time.

Illiquidity is a reflection of a collective action problem: the fear of each creditor that the refinancing it could provide would leak out to other creditors. The current liquidity crisis is directly related to the heterogeneity among creditors, a key characteristic of the current debt situation. While in the past, the debts of L&LMICs were largely due to Paris Club creditors, debts to private creditors (41% of the stock) and to China (10%) now loom large. Such heterogeneity favors self-fulfilling negative expectations that can lead to a "bad equilibrium": each creditor, on its own, would roll over its loans, but none eventually does so because they expect others to exit and do not want to end up holding riskier claims. Unaddressed, this leads solvent countries to move rapidly towards debt distress. This happens in several ways. Countries that rely on short-term or collateralized debt to refinance maturities pile up expensive debt rapidly. They reduce investment, leading to a growth slowdown. They also adjust through belt-tightening, ending with social wounds and political instability. To avoid such outcomes that ultimately hurt them, a coordinated set of creditors should provide re-lending in a concerted effort.

Capital markets are known for exhibiting bouts of exuberance followed by periods of gloom, but a lender of last resort can, in theory, help. It solves the expectation problem by sending a signal to all creditors that the debtor is solvent and can be safely refinanced. The IMF plays that role by putting its own funds at risk and setting conditions to avoid the classic moral hazard problem of a debtor using new funding to avoid, rather than support, adjustment. IMF support can also be used to repay other debts and can serve as a source of funding for a refinancing strategy. MDBs' direct budget support operation has also at time supported a refinancing strategy, either directly, or in subsequently refinancing IMF loans.

Large, bunched redemptions would lead to distribute scarce MDB funding to private creditors rather than countries themselves. It can also create a debt structure that becomes less flexible in the event of subsequent shocks.

In the current situation, even though the signaling function has great value, a solution that mainly relies on the refinancing of IFIs is neither realistic nor desirable. Given large, bunched redemptions in the coming years, such policy would end up distributing scarce IFI funding to creditors rather than to poor countries that need it. Moreover, IFIs-backed refinancing can create a debt structure that becomes less flexible in the event of subsequent shocks. Such debt inflexibility may reduce incentives for official and private creditors to lend in the future.

Therefore, while IFIs intervention is necessary, it needs to encourage the rescheduling of bilateral and private creditors. To work, such an effort requires the ex-ante political support from all key players -- developing countries, private and official creditors, and IFIs, under an agreed framework with G20 support.

Box 1. Lessons from the DSSI

The COVID-19 crisis in 2020-2021 led to the creation of the Debt Service Suspension Initiative (DSSI) in April 2020, driven by a fear that markets would freeze. The DSSI provided a much-needed fiscal breathing space to 46 developing countries (Brautigam and Huang 2023). Altogether, they rescheduled a total of about $13b of debt service that came due in 2020-2021 (around 4% of their fiscal revenues), freeing up funds to mitigate the impact of the pandemic. However, the DSSI was designed for a world with massive capital flight from developing markets. Apart from a brief period in the spring of 2020, the opposite occurred: massively expansive monetary and fiscal policies in advanced economies sent billions of dollars to the developing world.

The current perception of the DSSI is overly negative. While it did free up scarce government revenues for COVID-related spending, its impact was limited owing to two factors. Firstly, many countries were deterred by the fear of being stigmatized and losing market access. Secondly, the private sector was not obligated to participate, and as a result, ended up shunning the initiative.

If those two elements could be improved, a renewed and enhanced DSSI would match the current circumstances much better. The major shift in market sentiment came with a bang in 2022. The rise of inflation led to global monetary tightening. By 2023, when risk spreads increased in every asset class, "frontier market" economies got cut off from primary issuance altogether. In 2023, not a single IDA country issued bonds. Net flows from China, which had started to decline after 2016, have collapsed by about 50% in these countries. While MDBs managed to surge in these countries in response to negative shocks with disbursement rising to historically high levels, much of this rise ended up leaking out in debt repayment to private and bilateral sources.

The two main question that arise are how to create incentives for creditors' participation, especially private creditors, and how to encourage countries to apply for such a program. The Debt Service Suspension Initiative only requested voluntary participation of private creditors. There was a fear that credit rating agencies would downgrade participating countries, but a careful dialogue managed to avoid such a situation, and none of the 44 participants were downgraded. However, many countries avoided participation, fearing a loss of market access. They key difference with 2020-21 is that net positive flows on debt were high in those years, and bond markets were ready to lend to LMICs. This has changed, as markets have now closed, and flows have become negative.

2. What countries and at what cost?

This section aims to provide an overview of our proposal at country level. Where would such programs be implemented? Who will participate? What are the amounts of debt at play? The conundrum faced by developing countries is the coincidence of large refinancing needs due to debt walls and shrinking supply of new loans.

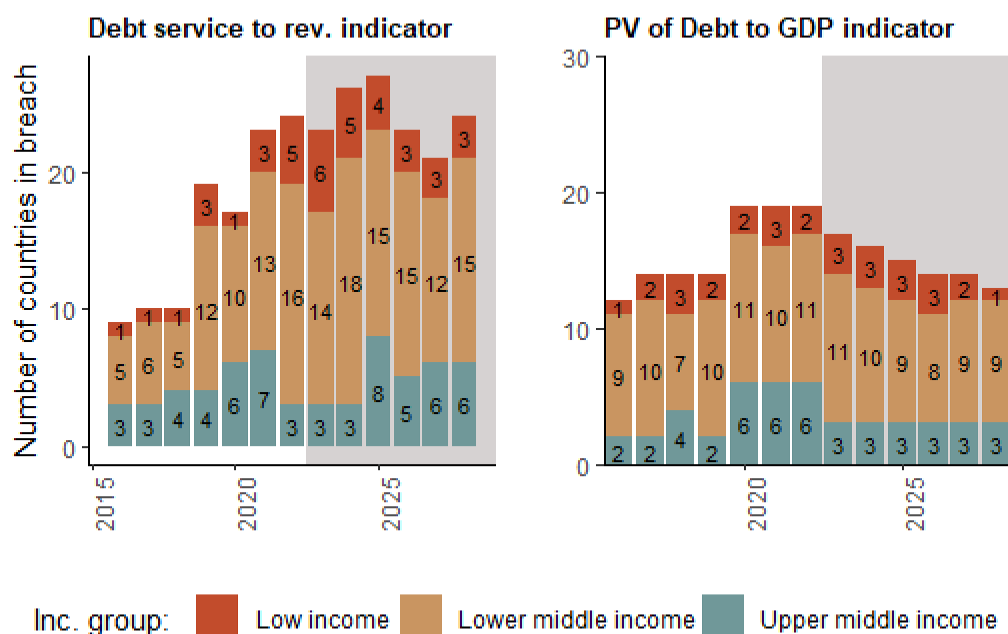
2.1. More than twenty LMICs with $1.7 trillion GDP and $600 billion in external debt could benefit

This proposal aims to solve the problem of the double pressure faced by many developing countries, namely an increased debt service burden and the scarcity of new financing. Debt service is expected to be high and concentrated over 2024-2026. Projections from a simple DSA model, under relatively conservative assumptions lead to estimate that it will represent 15% of government revenues for the median LMICs. However, this median hides significant variations across countries, as many countries will have large refinancing need in one or more years.

Using the IMF/WB's LIC-DSF thresholds, which include stock and flow tests, we have classified debtors as illiquid or insolvent. **On this basis, FDL estimates that of the 104 developing countries, 25 countries can be classified as illiquid but solvent** – meaning that they do not breach insolvency thresholds, yet they are exceeding or will exceed the debt service to revenue thresholds within the next 5 years. Among those, 21 are L&LMICs, and of these, 18 are eligible to some form of World Bank concessional support (IDA or blend). This problem peaks in 2024-25 (Figure 2). An alternative, pessimistic scenario (where interest rates remain high until 2028) shows broadly similar results, but with more persistent flow breaches over the period.

At the same time, 19 (different) countries are currently facing debt stock problems in the sense that their debt to GDP ratio is above risks thresholds as defined by the IMF and the World Bank. These countries do not all need debt reduction, but they do require sustained fiscal consolidation. In some of these cases, the fiscal adjustment path of these countries could avoid insolvency, and their financial problems could be addressed through rescheduling. While some of these could participate in the bridge program, we do not include them in our estimates below.

Figure 2: Number of Illiquid but solvent countries. And number of insolvent countries



Sources: FDL computations using World Bank IDS 2022 and IMF data. More details in Albinet, Kessler and Brancher (2023)
Note: Number of countries in breach under our baseline scenario of the IMF-WB defined threshold for the respective indicator, which depends on "Debt Carrying Capacity". Countries under the MAC-DSF are assumed to be "Strong", i.e. to have the highest thresholds possible.

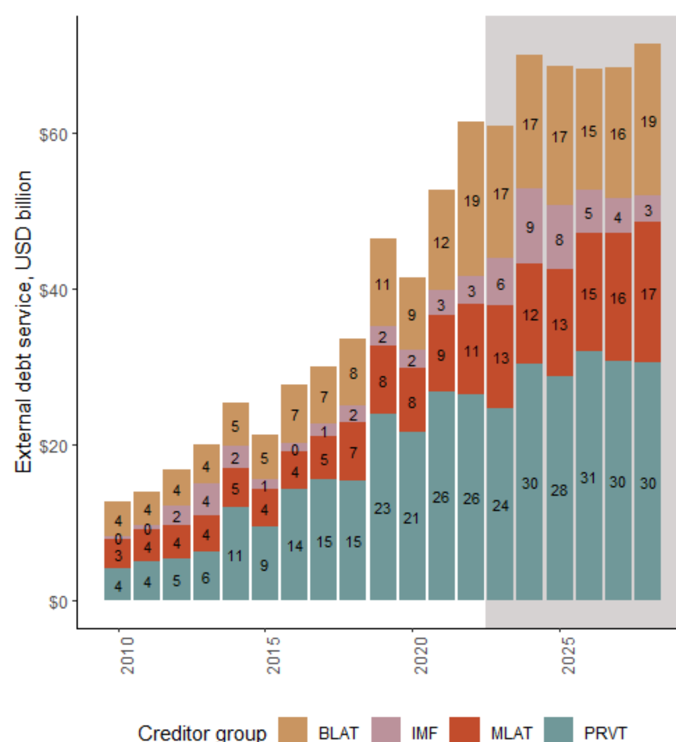
The illiquidity risk would not be a major issue if developing countries could borrow and roll over their debt on reasonable terms. However, most of them are currently unable to access the markets. Very few L&LMICs were able to issue bonds in 2022, and none since March 2023 (Properzi, 2023). Meanwhile, Chinese development finance has declined (Moses et al. 2023), even though other forms of financing, such as central bank swaps, have helped offset the decline in net flows (Parks et al. 2023).

This combination of debt walls and shrinking supply of loans creates a dangerous combination. We estimate that total debt service due in 2024 by those 21 illiquid L&LMICs is about $70 billion, of which $30 billion will have to be paid to the private sector and $17 billion to bilateral creditors (Figure 3). If the IMF and the MDB system were to refinance these sums on their own, they would need to roughly triple their annual assistance. Even narrowing their support to the 17 countries which were eligible in the DSSI (i.e. excluding IBRD-only countries such as Egypt and Tunisia), financing external needs would be substantial: the multilateral system would need to increase its funding from $11 to $28 billion annually for this subset

21 low- and lower-middle-income countries face liquidity risks. Together, they will owe about $30 billion to private creditors between 2024 and 2028, and $17 billion to bilateral creditors. If IFIs had to refinance only a share of these sums on their own, it would amount to tripling their support.

of poorer countries. For a sense of scale, the entire disbursements of IDA and the PRGT in 2022 were $27 billion and about $4 billion respectively.

Figure 3: Debt service of countries at liquidity risk



Note: This includes all 21 low- and lower-middle income countries with above flow thresholds but below stock thresholds in 2022.

Given their existing financing firepower, refinancing maturities coming due with IFIs funds is not a viable option. IFIs can refinance the repayment of large debt service - as they are attempting to do now in Kenya for example[5] - for a few countries only. But they cannot afford to do this for all L&LMICs facing roll-over difficulties and finance development at the same time. If walls are not refinanced by the IFIs, another possibility is that countries would use their foreign exchange reserves as a first line of defense, but this too has its limitations and builds up further difficulties down the line: countries in liquidity difficulties held reserves equivalent to about 2 years of debt service in 2022, down from 5 in 2017.[6] If no solution is found to roll-over repayments walls, countries receiving more IFI funding would be pushed to allocate much of these funds to debt service rather than to development. The opportunity to enhance development would be lost, hurting all actors involved.

2.2. What could country programs look like?

Countries that apply for the bridge program would need to present a growth plan that keeps debt at a sustainable level. To make things concrete, let us take the example of a country that

[5] https://www.reuters.com/world/africa/world-bank-sees-12-billion-support-kenya-over-next-3-years-2023-11-20/

[6] There are data uncertainties surrounding reserves, but the downward trend for "breachers" seems clear.

has been hit by a series of negative shocks, with a modest external debt, but a large maturity coming due. Typically, it will be confronted with three separate but interrelated challenges. First, it needs to continue to neutralize the effects of the recent negative shocks by re-establishing internal and external balances. Second, it must prepare for the coming debt repayment wall. And third, it must stimulate economic recovery and put the economy on a new growth path. The resulting country program will need to be tailored to each case, unlike the rest of the initiative which would be relatively automatic.

The first adjustment leg is painful, but it will be eased by the other two legs of the program. Most L&LMICs have been struggling for several years with the necessity to reduce domestic expenditures and imports in the face of deteriorating terms of trade and reduced external capital flows. IMF support is helpful in allowing for a smoother adjustment. However, this support has been criticized for being overly focused on the short term – resulting in undue austerity, which negatively impacts on social cohesion and growth. Following several years of belt tightening, the coming repayment walls exacerbate these difficulties immensely.

The goal of the second rescheduling leg is to lower the repayment walls so that debt service falls below a reasonable threshold, such as 15% of fiscal revenues.[7] The main objective here is to roll over the repayment of principal. In some cases, capitalizing some of the early interest payments could also be useful, when the need to smooth the recent shocks is pressing, and it could also be feasible for countries with sufficient debt space available. As long as the interest costs are at least partially paid, rescheduling debt at coupon rates close to the country's growth rate will prevent the debt burden from deteriorating over time. Such a rule-of-thumb also creates good incentives to structure and finance domestic programs that can lead to a substantial recovery.

The third leg of the process is to provide additional financing through MDBs. This will complement debt rescheduling and create financial space for an increase in investment – public and private - leading to a recovery of growth. It will help reverse the ongoing deterioration that threatens to undo two decades of progress, and support LMICs in transitioning to a phase where they can start adjusting to climate change in earnest.

Adding liquidity and growth legs to the program helps alleviate short-term pressures on fiscal space and on the domestic capital market. The prospect of future growth also creates more debt and fiscal space, which can be used to protect the poorest, as well as the provision of essential human and infrastructural public services. This, in turn, improves the prospects for growth further.

To reignite growth prospects, new opportunities need to be unlocked through new financing. These are likely to center around food security, digitalization, the re-localization of value chains, and the rising demand for new minerals. But the funding needs are most apparent and substantial with respect to the green transition. Climate change is impeding growth prospects in low-income countries the most, partly due to their geographical location, and to their population's greater vulnerability and inability to adapt to climate risks. Green growth largely involves implementing public policies that offset these negative forces. Investments in

[7] The exact ratio would of course need to be precisely determined in future discussions, and could vary according to some criterion, including the IMF/WB determined debt carrying capacity.

adaptation to climate change include projects to build defenses against sea-level rise, reduce salinity intrusion and floods, make resilient road and bridge infrastructure, and increase water conservation while improving the resilience of agriculture. In the long run, green growth will also offer new opportunities - from the production of carbon offsets to the export of green manufacturing products.

Different countries may also require specific reforms to reinforce their new medium-term sustainable growth and development strategy. Progress in debt management and debt transparency might be an important prerequisite, to build trust among different parties and avoid repeating past mistakes. In retrospect, countries that moved from low to middle income status after they exited the HIPIC process saw donors' external discipline decline before they could build their own institutional safeguards - such as sufficient data transparency, or legislative and constitutional oversight. Other reforms which have become more pressing include measures to expand domestic capital markets and boost domestic resource mobilization.

Once countries express interest in joining the "bridge program", they should quickly develop national adjustment and recovery programs with the participation of civil society. World Bank Country Climate and Development Reports can provide guidance for investments required for adaptation and mitigation, but they should not be a prerequisite. The more ambitious the program, the greater the financing gap that needs to be filled by the MDBs, and the more ambitious the country's pledges. It may take longer to negotiate more ambitious programs, but it will be worth the time spent. Countries should apply early, before their liquidity pressures become too intense.

Ultimately, to attract countries to the "bridge program", there should be some degree of automaticity and certainty over the treatment of debt. We analyze this in the last section of this paper. The fear of stigma effects and the temptation to "muddle through" is likely to discourage initial participants. Therefore, it is important to encourage a few potential "first movers" at the onset to demonstrate the program attractiveness.

3. The central challenges: stepped-up financing from IFIs, and adequate creditor incentives

3.1. Financing rules for the IMF and the World Bank

If a stabilization and growth program is adopted, its time frame must be adapted to the challenges. To be credible, the time frame should be longer than the typical 3-year IMF program. This would provide enough time to alleviate liquidity pressures and focus on new investments. The horizon could be set at 5 years, and disbursement could be structured in ways that support not just stabilization effort, but also the investment objectives. New types of investments in adaptation to climate change require a much longer period of implementation. The horizon could also be adapted to the country's need.

Longer programs with both macro and structural policy commitments require the active cooperation of the IMF and the WB, as was done for managing HIPC programs. There is an increased awareness that such cooperation should improve (AfDB, 2017, IEG 2023). There are various ways to implement such a cooperative venture under current rules. While the IMF Standby Credit Facility programs are limited to 3 years, if longer adjustments support is needed, an Extended Credit Facility program can be easily extended to 5 years. The IMF's new RST program should facilitate improved coordination around the financing of a green transition. For the WB and other MDBs, country strategies typically cover five years. Rather than just plans, as is usually the case, these have to become firm commitments, akin to financial assurances. This can increase the credibility of the national program, facilitating a domestic supply response, and incentivizing creditors to bet on the country's future. The objective here is to develop an actual project pipeline over the next 5 years, with firmer financial commitment to the whole period, as long as particular country pledges are satisfied. The role of country platforms as developed in the G20 Independent Expert Groups, will be important. Budget support operations would have to be larger than in the recent past, both as a means to disburse faster and also to provide a credible mechanism for the country to commit to structural and growth policies.

IFI support would require both financial and logistical coordination, building on existing plans of joint MDB country platforms and financial expansion plans.

Ideally, these programs would allow L&LMICs to bridge the gap between their current debt crisis and the start of their adjustment to climate change. The additional investment needs for the green transition have been estimated by Songwe et al (2022). Until 2030, they estimate that an additional 2% GDP needs to be invested, with 1% GDP coming from external sources, and 1% from internal ones. If the additional funding is focused on the group of illiquid LMICs and their green transition, this represents an additional MDB flow of around $20b/year – a rise of about 50% of their disbursements in these countries during the program period.

A main determinant of the cost of the proposed program for the IFIs is the size of the country group allowed to participate. The original DSSI group included only the IDA countries plus Angola. It should ideally be extended to all LMICs, including countries such as Tunisia and Egypt, which are experiencing similar problems.

In this proposed new program, the PRGT, the RST, IDA, and the IBRD would be key players, working in association with the regional development banks. They would need to scale up their financial involvement, as well as find new ways to coordinate their conditionality, and the monitoring of programs in ways that maximize growth. While the IBRD's ability to lend more is now possible due to rising leverage, the PRGF requires additional subsidy funds to be able to scale up. Similarly, scaling up IDA commitments would require raising additional funds on an exceptional basis, perhaps in a special window devoted to supporting debt restructuring (in our above estimate, around $3b would have to come from IDA, and $17b from the IBRD/RDBs). More effort should also go into attracting more SDRs to the IFIs, and to increase further the leveraging of IBRD's capital.

3.2. Incentivizing creditors

The main challenge of our proposal is to make the initiative appealing both to L&LMICs and creditors. There are two different approaches to achieve this. The first one is faster and more automatic, while the second is more tailored and negotiated on a case-by-case basis. There is a tension between automaticity and negotiations. Automaticity is attractive in its predictability and speed, but some countries would be deterred by the risk of stigma, credit downgrade, and a possible loss of market access. Market-friendly negotiations may take a long time in bargaining and could lead powerful creditors to extract more concessions. On the other hand, they could avoid a default event and can support a quicker return to the market.

While more consultations are needed to determine the mechanisms that would work given the circumstances, it is important to stress that from a first principles basis, there is no loss for creditors to accept deferred payment in the case of illiquidity. Instead, creditors should benefit by not forcing a costly and protracted default. Creditors may be skeptical about deferring claims, fearing that they might lose more money later. Therefore, it is crucial to assure them on several fronts: that large negative net transfers to any type of creditor will be avoided; that large transfers from MDBs will be invested to support efforts towards adjustment, recovery, and regaining market access.

Official debt rescheduling could be easier to secure as it follows pre-existing traditions, both within the Paris Club and China. The latter need to be assured that private creditors will follow suit. For Paris Club creditors, this is a reminder of the so-called "Evian approach", where a triage process based on the Debt Sustainability Analysis led to a rescheduling on "classic" or "Houston" terms if the country has liquidity problems (Cheng and al, 2016). It can then pre-define the terms of rescheduling, so that the approach becomes speedy and quasi-automatic. For Chinese creditor institutions, providing maturity extensions would not be new as the country has a long tradition of doing so unilaterally (Horn et al. 2022).

There are a number of obstacles to take into account: the shadow of the DSSI is looming. From that experience, Chinese policymakers will require an equivalent participation by commercial creditors and commitments by MDBs. On the latter, the Chinese government had criticized the MDBs for not sufficiently sharing the burden, but it should be comfortable with the MDBs putting in additional flows that aim at increasing growth and the country's future capacity to repay its debts. Once the country has agreed to a program, which includes conditions set out in the IMF/WB DSA, the bilateral debt restructuring can follow a rapid and predictable procedure that would be quasi-automatic – if bilateral creditors agree to set up such rules ex-ante.[8]

Private creditors should also find their best interests in working constructively on such a program. The argument in favor of the bridge does not rely on the goodness of heart of private creditors, but on their best interest: countries in full-fledged liquidity crises also experience large declines in bond prices and rising yields, which destroys investors' value. While in the short term, MDBs have accepted that their financing leaks out, this cannot be a sustainable situation.

[8] For example, a 10-year rescheduling of all principal payment due within the 5 years of the program, at the existing coupon rate or 5% (whichever is lower), with principal repaid in equal instalments between years 5-10.

A convincing plan should include a sustainable rise in MDB funding to reduce the risk of default and lead to a rise in bond prices.

This could constitute a pre-emptive, shallow default, which would allow rapid renewed market access. Even if voluntary, a change of terms of bonds would in most cases constitute an event of default. However, the literature is clear: pre-emptive and shallow defaults with no reduction in net present values has led to shorter losses of market access, lower impact on economic growth and other disruptions (Asonuma and Trebesch, 2016) in the past. To reassure countries, early engagement with private creditors and credit rating agencies is essential, thus stressing the value of the proposal to investors.

Private creditors would have to accept terms broadly, similar to those provided by the public sector. Importantly, they would reschedule all principal repayment falling due during the period of the program. Unlike the DSSI, debt service would not be frozen: most interests would be paid - some could be capitalized for the early period. A major issue would be to determine the interest rate used for the rescheduling. A natural place to start would be the country's growth rate. Another option is to use the coupon rate of the original contract. The important point is given that the goal of rescheduling is to reduce risk, the interest rate to use should be below the ex-ante yield. Beyond the interest rate, the maturity of the extension will also matter. Countries that see their problems as temporary and have robust recovery/growth strategies, might choose shorter and cheaper terms. On the other hand, creditors might prefer a "short leash" for countries with structural weaknesses and condition renewal on reform.

Providing private creditors with costly guarantees on rescheduled debt should be avoided. The return on IFI financing is likely to be much higher when invested in the country, and to the extent that it generates investment and growth, it also increases the likelihood for creditors of being repaid. In addition, at current low level of real interest rates, the cost of guaranteeing future payments is high. The situation is different from the 1980s, where the aim of collateralizing Brady bonds was to help create liquid assets out of illiquid bank loans. Indeed, recent rescheduling negotiations – for example in Ecuador and Pakistan - did not involve guarantees to rescheduled private bonds. More affordable incentives could be found, such as the payment of an upfront coupon to encourage early participation. Where guarantees financed by MDBs might be more useful is in helping countries re-access the markets once their program is completed – the experience with policy-based guarantees would be helpful in designing more effective new instruments. New initiatives, such as the launch of commodity-contingent bonds, or the creation of an African LSF, can play an important role in making the next wave of borrowing more (Cohen et al. 2022).

Finally, methodology is important: one reason of the failure of the Common Framework is that official and private negotiations are disjointed. Private creditors should be able to enter the negotiating process earlier. There has been accumulated anger among private creditors about being excluded from the conversation, while being asked to provide relief like the bilateral donors. Bringing them to the table early on is therefore preferable to help build more buy-in and speed up the process (Hagan 2023). Opening an early dialogue with the credit agencies is also necessary to make them more aware of the risks and benefits involved with a rescheduling or lack thereof, whilst helping them incorporate such considerations into their evaluation methods.

Conclusion

In sum, the "bridge proposal" offers countries the possibility of alleviating short-term concerns to be able to bridge over debt illiquidity and be in a position to focus on long-term sustainability objectives. It straddles a set of complex constraints and incentives between creditors, countries, and international institutions. A simple idea sits at its core: a proposal is to reschedule debt walls coming due, for illiquid but solvent countries, in order to avoid an unneeded default, and more broadly, to avoid an unnecessary systemic debt crisis. To make the offer more attractive, MDBs would be willing to provide more financing than in the past, a down-payment on their ongoing scaling-up efforts. This, however, would come with two conditions. First, the offer will be reserved for countries willing to not just stabilize their economy, but also engage in the deeper reforms needed to move into a green recovery, so that as they exit the program in 5 years, they are firmly set on a new green growth path. And second, the offer would only materialize if creditors are willing to reschedule their debt sufficiently so as to avoid that leakages make the program unworkable.

Because of the large set of actors and initial conditions, this paper intentionally leaves many options open. The automaticity of the process, the length of programs, the combination of incentives, the type of IMF/MDB involvement, all have to be subject to consultations. A more automatic process would accelerate treatments, but might be seen as too coercive by countries themselves and by their creditors alike. Allowing for too many loose parameters would lead to negotiations and negate the urgency of solving the liquidity crisis.

Our main contribution is to highlight a gap and open a debate. Left unaddressed, the ongoing liquidity crisis will lead to development and climate disasters. Stuck between inexistent fiscal space and the obligation to repay their debt, countries might suffer a lost decade. The global economy cannot afford a lost decade of developing world growth and delays in addressing climate change. Growing out of the debt problem, and providing protection against climate vulnerability are the best ways out of the current predicament. The international financial architecture is not equipped to manage such cases, and needs to augments its tool-box. The program is made all the more necessary by the fact that the MDBs are gearing to scale up their funding, but that these efforts might not contribute to new investments if debt service is not rescheduled, with strong country-owned investment programs.

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