Towards an emerging consensus?

Co-organisers' Summary of the joint SIIS-FDL workshop:

"Common Solutions for Global Sustainable Development Finance:

Perspectives and Case Studies"

Co-organisers: Yu YE, Martin KESSLER

Shanghai, November 11 and 12

On 11 and 12 November, the Shanghai Institutes for International Studies (SIIS) and the Finance for Development Lab (FDL) jointly hosted a high-level workshop focused on development finance. This conference was an opportunity to share perspectives across continents, spanning various sectors, and views on the challenges within the development finance architecture. Participants from China, which included think-tank researchers, academics, and officials, discussed the recent developments in debt and financing issues with their counterparts from Europe, the Americas, Africa, and Asia. The striking conclusion is the extent to which perspectives have converged, but also the long journey ahead to address the challenges that lie before us.

During the six conference sessions, four central themes emerged, each of which highlighted broad areas of consensus but also showed challenges in translating agreements into action. The narrative that sparked the most discussions among economists and practitioners from various geographies can be summarized as follows:

(i) Numerous countries are experiencing diminished growth prospects under current economic models. Fostering growth will require different financing strategies, focusing more on investment and export diversification. However, high debt levels limit these options, and new financing must be somewhat aligned between project support and budget needs to prevent excessive fragmentation.

(ii) In some cases, restructuring is necessary. However, there is a general dissatisfaction with current existing frameworks. There has been mutual learning and progress across borrowing countries, bilateral creditors (Paris Club, China, and others), multilateral institutions, and the private sector, but a shift in approach is necessary to resolve future cases with the appropriate depth and speed.

(iii) For other cases, liquidity provision is essential, and all creditors and potential finance providers must play their part. Key questions remain, including moral hazard for borrowing countries and the role of private creditors.

(iv) Overall, the multilateral landscape is becoming more diverse, presenting opportunities for new approaches, but there are also growing challenges in fragmentation.

The objective of this conference was to spark new conversations and continue building consensus between think-tanks and practitioners.

I. The macroeconomic environment signals reduced growth perspectives, which must translate into different financing strategies

This has direct implications for a range of countries: there is an urgency to find new growth opportunities to avoid a systemic debt crisis. On the financing side, it implies more sustainable flows, including Foreign Direct Investments, the reform of MDBs, and the emergence of new actors.

The scene-setting session took stock of major global trends: a deteriorated macro-financial environment with slowing growth perspectives and dwindling export opportunities for emerging markets and developing countries. In addition, the cost of debt has been growing, and interest expenses are now higher than they have ever been. In many ways, this is reminiscent of the Latin American experience of the 1980s and its lost decade. The parallels include both private flows (in the 1980s, commercial banks and in the 2000s, Eurobonds) and bilateral lending (Japan and other OECD countries in the 1980s, China in the 2000s).

Several speakers highlighted the need to shift to an FDI-based model of financial engagement and to generate more foreign earnings from investments. A point of discussion was how the infrastructure-based lending spree could lead to a resurgence of growth. How can diversification progress? China's case can provide lessons for other developing countries, but it also has specific characteristics that are hard to replicate. Infrastructure loans have had significant economic returns but were not always self-sustaining financially. It will also be important to improve the "localisation" of economic activities to create more jobs in these countries. This year's FOCAC also included new areas of focus: peace, security, technology, and women's issues. It also emphasized smaller projects, where development, local impact and reputation will be primary objectives.

Defining where and how aid and development finance will be delivered remains the key challenge. There are contrasting views: Chinese policymakers tend to consider that project financing is growth-enhancing while budget support can be inefficient. In contrast, bond investors provide funding that is not tied to specific uses. To some extent, OECD policymakers and some MDBs have sought to increase the share of budget support. In a way, these channels can be complementary: infrastructure financing and the flexibility linked with direct budget financing are both useful. However, this creates difficult trade-offs for policy-makers. Indeed, interactions between Chinese and private investments are complex: bond investors tend to react negatively to news of large Chinese investments.

II. Countries with debt overhang must restructure early and rely on the progress made through multilateral action.

Major gaps remain on how to better integrate a new major actor such as China; and how to better use the gains from a multilateral approach for Chinese actors.

Participants agreed that global treatments are still insufficient. The cases of Sri Lanka and Ethiopia were presented: Sri Lanka as an example where treatment was too shallow; and Ethiopia as one where treatment was too long and generated considerable uncertainty. China's engagement with the Common Framework or with the multilateral system in the case of Sri Lanka has shown that multilateral approaches can work, albeit imperfectly. Chinese institutions and loans do not fit the categories defined for Paris Club countries, and understanding and adapting concepts of COT, NPV, and other complex technical topics has required time and efforts. The learning curve has been significant, and China has adopted some of the rules of restructuring.

Global systems could evolve to reflect the new landscape. In particular, the Debt Sustainability Analysis and its ability to reflect the realities of debt-carrying capacity for countries like Sri Lanka and Pakistan were discussed. Participants suggested that these rules should evolve and that China has an opportunity to actively drive change in these rules. There are also instances where China prefers a bilateral approach, although this could potentially be against its own interests, ultimately ending up subsidizing other creditors, whereas a multilateral approach could make treatment more comparable. It should also raise important questions: Can COT be applied when a specific project is attached to it? Other participants suggested that China should pay more attention to the specifics of restructuring: the role of short-term debt, the domestic/external distinctions, and other parameters that delay restructuring processes.

Many questioned the willingness of the private sector to participate in restructuring. Is COT an equitable framework? Various views were expressed: on the one hand, private lending tends to be at a higher rate; but on the other hand, official lenders use their loans not only for financial reasons but also for trade or geopolitical reasons. Defining fair criteria remains a difficult task. The question of whether re-entry into the Eurobonds market is premature was also raised. The emergence of new instruments with better liquidity protection could help mitigate risks.

III. Options facing countries with acute liquidity tensions are limited. Concerted action will help, but no concrete framework has emerged yet

A major challenge in the coming years is to support growth in a world with high interest rates. IMF programs and targets are seen as somewhat arbitrary and fragile. New concerted action can help support growth prospects and reduce liquidity risks in the short and medium term. The symposium outlined how China and others could advance on such challenges. Research from a Chinese institute highlighted how the pressure of high debt service has become a direct threat to more than 20 countries. The combination of high rollover needs and high US interest rates creates a complex environment to navigate. Despite the mobilisation of multilateral actors, net flows to many developing countries have turned negative. The case of Pakistan was discussed to illustrate how such a treatment could make the macro-financial framework more realistic than the current IMF program, thus enabling higher public spending while driving significant revenue mobilisation.

Chinese creditors show significant interest in generating coordinated solutions. Speakers supported the idea of an expanded financial safety net, with scaled-up ODA and concessional funds. They also highlighted the role of emerging donors and Sovereign Wealth Funds in driving liquidity provision. A key question is how China can contribute given that it does not provide direct financial support (to the important exception of currency swap lines). It cannot act as a lender of last resort, but its role in fostering productive infrastructure is important.

Key questions remain to turn those plans into action. Participants were concerned about possible moral hazard issues: will countries be able to drive the necessary reforms? Who will monitor them? The importance of regional financial safety nets was also highlighted. Some participants pointed out that they worked in steps with the IMF, as was the case during the European debt crisis, especially since IMF technical knowledge and ability to request difficult measures were irreplaceable. At the same time, programs should better identify growth opportunities.

Private sector participation is also a key issue. Participants noted the different incentives faced by private actors**.** Current Eurobond structures create liquidity problems when they amortize, especially since high interest rates limit the ability of countries to refinance on private markets. Nascent "resilient instruments" could help but are still limited to a few emerging markets.

IV. The overall financing landscape is fragmenting, creating problems but also opportunities

Demand for concessional financing is increasing, but supply will be limited. The aid landscape is fragmenting, with donors preferring trust funds and vertical funds in recent years, while their support for horizontal institutions such as IDA has stagnated. From a recipient country's point of view, this creates inefficiencies, with a multitude of providers and insufficient coordination.

At the same time, institutions such as the World Bank and the Asian Development Bank (and others) are reforming fast, while new MDBs bring new approaches. Senior staff from several MDBs presented their approaches to mitigate these risks, relying on faster approvals, streamlined decision-making, more concerted approaches with countries, as well as enhanced collaborations among MDBs. The role of local currency financing was highlighted, especially in the case of the New Development Bank, for which it is a central aspect of its strategy. This is also a key part of the strategy to position Public Development Banks as essential actors and co-investors alongside multilateral and bilateral lenders.

Speakers from several lending institutions emphasized their consideration of countries' capacities, including through capacity building, to manage projects; and extend funding timelines for projects with long profitability horizons. They also highlighted the fact that collaboration with multilateral institutions was increasingly necessary, and discussed how they would strengthen their evaluation practices.

At the same time, key questions remained: the role of private sector mobilization in project financing is seen as essential by some, but its risks were highlighted by others. The risks of subsidizing private profits were emphasized. The role of conditionality is also disputed: China prefers to fund projects directly and avoid policy conditions, while traditional MDBs focus on governance. While there can be complementarities, this can also lead to tensions and forum shopping.

Concluding remarks

This conference highlighted how far the global financial system has evolved in the last few years, as well as the major challenges it faces. This will likely require major reforms in the multilateral systems, OECD countries, the private sector, and Chinese institutions. How to coordinate these reforms should be the subject of much more collaborative research.