Collaborative efforts to stimulate sustainable investment for COVID-19 recovery in developing countries

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Theme

Limited fiscal space in many developing countries demands collective efforts and EU leadership to help improve their macro-economic conditions and attract more investments for a higher impact and sustainability for recovery from COVID-19.

Summary

Recovery from COVID-19 will require the capacity to mobilise sustainable, green, inclusive and gender-sensitive investments to achieve sustainable development goals. Given the dramatic socio-economic consequences of the protracted pandemic crisis, efforts to build back better must be carried out collectively, in a cooperative and inclusive manner. Given the limited fiscal space of many developing countries, collective efforts to help improve their macro-economic conditions, and in particular more forcefully addressing their unsustainable debt vulnerabilities, has become ever more urgent. So has the need to tackle illicit financial flows, which deprive developing countries from much-needed resources for recovery. The EU is well placed to take the lead in these endeavours. International and national financial institutions for development, including those in Europe, have stepped up their efforts to respond to the crisis. But to truly unleash their potential to leverage private finance at the right scale, in a truly countercyclical and more impactful manner, their approaches must be adjusted, building on better practices and encouraging innovation in a cooperative and collaborative manner based on local needs, dynamics and actors. There too, the EU has the potential to play a more catalytic role, mobilising its wide array of instruments and institutions in a more coherent and complementarity manner, and in partnership with developing countries, notably in Africa, so as to stimulate sustainable, transformative and inclusive investment at the right scale.

Analysis

The COVID-19 crisis is causing dramatic health and socio-economic impacts, affecting primarily the most vulnerable peoples and countries, and significantly increasing inequality. While the recession is global, poorer countries are less able to adopt rescue and countercyclical measures to support their populations and economies. Sub-Saharan Africa is experiencing the worst contraction of its economy on record, with an annual average contraction of -3% of its GDP in 2020, which is even greater in countries highly dependent on commodity exports and tourism. This could cost 25 to 30 million jobs and increase poverty by 10%, pushing up to 50 million additional people below the poverty line.

Boosting quality public investment is highly recommended to speed up COVID-19 recovery and job creation, with a strong emphasis on climate, sustainability and gender dimensions, in an effort to build back better. Yet the capacity to do so of poorer, but also many emerging countries, is highly constrained.

While developing countries are stretching their limited fiscal space to address emergency health and socio-economic distress, they must prepare now for the long road to recovery, for which they will also need support. Boosting collaborative efforts and partnerships, at both the domestic and international levels, will be a critical factor to promote their sustainable and inclusive recovery, notably through sustainable, green, gender-sensitive and inclusive investment to build back better. The EU is a committed partner for Africa in this endeavour. Joining forces and identifying synergies and complementarity are key to unleashing the potential for sustainable investment.

(1) Strategic and macro-economic considerations

Europe is adopting a 'policy first' approach, defining key policy priorities and actions, combined with a whole-of-government approach, to help ensure that support for investment is well anchored in a coherent, sustainable, green, gender-sensitive and inclusive approach to development. Given the emphasis on the EU's geostrategic ambitions, the European approach to partnership and development aims to become more strategic, including collaborative efforts at the global, regional and country levels in response to the COVID-19 crisis.

Support for enhanced macro-economic conditions and governance, and reforms towards a conducive investment climate and business environment at the national and international levels are among the EU's priorities. In the context of its global response to the COVID-19 crisis, the EU has speedily been providing such support, notably by allocating €3 billion for macro-financial assistance to 10 neighbouring countries in the form of loans (Bilal, 2020). The EU has also boosted its budget support by grants to developing countries and by accompanying them in their adjustment measures. Given the scale of the crisis and its socio-economic impact, the EU could perhaps also consider providing some additional budget support in the form of highly concessional loans, mobilising the European Investment Bank's firepower, which it is not allowed to do at the moment. Yet this should be done only after very careful consideration of the debt burdens of many developing countries.

(2) Addressing debt vulnerabilities

Debt vulnerabilities, already present before 2020, have been heightened for an increasing number of emerging and developing countries as a result of the COVID-19 crisis. Around half of low-income countries and several emerging economies, including Egypt, Ghana, Kenya and South Africa, are in –or at high risk of– a debt crisis, as their public debts continue to rise. Argentina experienced another debt default in May and Zambia defaulted in November 2020. More could follow if no speedy action is taken by the international creditor community.

The G20, together with the Paris Club, have agreed a temporary suspension of debt services for low-income countries (LICs). The Debt Service Suspension Initiative (DSSI), adopted in April 2020 until the end of the year, was renewed by the G20 in November 2020 for another six months until mid-2021, with the possibility of a further extension beyond June 2021, to be decided at the World Bank-International Monetary Fund (IMF) Spring meeting of 2021. While this is a welcome decision, it is insufficient one.

As argued by the IMF's Managing Director Kristalina Georgieva and her colleagues, a reform of the international debt architecture is urgently needed. Indeed, more ambitious measures need to be taken to avoid a serious debt crisis. Debt relief should be considered for the countries most in need, including middle-income countries when necessary. This can be done on a case-by-case approach, but under the common approved framework that brings in all official bilateral creditors, including China, as well as private creditors (notably through the Institute of International Finance, which regroups most private creditors). Without which a comprehensive solution to debt, sustainability is no longer possible.

The Common Framework for Debt Treatments beyond the DSSI is a first step in the right direction. It foresees the possibility of considering debt restructuring for poorer countries on a case-by-case basis, also with the participation of private creditors. But, as it stands, the Common Framework still falls short of: (1) identifying specific measures; (2) reaching out to a broader range of developing countries in debt distress; and (3) addressing systemic issues around the international debt architecture. Nonetheless, it is an important diplomatic effort to the extent that it brings together, under the same umbrella, Paris Club members and other public debt creditors, notably China, which alone owns 63% of the combined sovereign debt held by G20 members by the end of 2019.

China has become a major actor for both public and private debt, as the distinction is not always straightforward in its state-owned enterprises and parastatal financial institutions. China has recently been renegotiating the public debt of several developing countries, including Kenya, Mozambique and Tanzania, and claims to have reached an agreement with 10 of the poorest countries –although the list is not public it apparently also includes Angola–. It is said to mainly take the form of deferral of payment.

Any global solution needs avoiding *ad hoc* approaches by individual debt creditors, which would run the risk of treating some creditors more favourably than others, undermining the incentives of the latter to join any comprehensive debt restructuring for a country with unsustainable debt. More coordinated action, as foreseen under the Common Framework, is the only sustainable approach. This should start with greater debt transparency, related notably to debt data (levels and conditions), debt sustainability assessment and debt restructuring processes.

The G20 should prioritise replenishing the Catastrophe Containment and Relief Trust (CCRT), through which the IMF has provided debt service relief to the world's 29 poorest and most vulnerable countries, amounting to almost US$500 million. The EU, through its membership of the G20, Paris Club and IMF, has a catalytic role to play in fostering a consensus towards adjustment and reforms to improve debt sustainability. The EU has already contributed €183 million to the CCRT, and could contribute more, including the IMF Poverty Reduction and Growth Trust.

Support for public debt management by developing countries and the tools provided by international financial institutions should also be enhanced. Special Drawing Rights (SDRs) under the IMF could be either reallocated to the countries most in need, as many advanced economies do not use their quotas, or new SDRs could be issued to help developing countries in dire need of support, including some middle-income countries and small island economies. The EU is rightly supporting a new general SDR allocation.

The EU has called for a Global Recovery Initiative, which would help address debt vulnerabilities in a more structural way, directly linking debt relief and investment to the Sustainable Development Goals (SDGs). This is an important endeavour, as the global community should seek to use the fiscal space that debt service suspension and debt relief could provide to developing countries to stimulate more sustainable, green and gender-sensitive investment, aligned with both the 2030 Agenda on Sustainable Development and the Paris Agreement.

Innovative and comprehensive approaches have been identified. These include conditional debt relief linked to sustainable investment commitments, special purpose vehicles and instruments, such as the issuance of a COVID-19 social bond (as done by the African Development Bank in Spring 2020 with the US$3 billion Fight COVID-19 Social Bond) and potentially a 'Green Recovery Bond', or debt-for-climate swaps for countries not yet too heavily indebted. The United Nations Commission for Africa has outlined a comprehensive framework to address debt vulnerabilities and finance a sustainable recovery (UNECA, 2020b). One of the key innovations centres on the proposal to set up a special purpose vehicle, the Liquidity and Sustainability Facility, capitalised up to US$50 billion through loans and guarantees by public development banks, with the possible guarantee of central banks and collaterals from government bonds. The Facility's purpose is to inject liquidity into developing countries, allowing lower-cost borrowing and sustainable investment, with the potential to leverage US$250 billion. The Facility could also help alleviate the debt burden of African countries, facilitating the payment of debt services obligations and debt swaps to exchange commercial debt for new concessional papers, converting debt into new securities with a longer maturity.

The EU and the African Union should speed up their efforts to come up with a common proposal in the context of the Common Framework, following the EU commitment to support 'a coordinated international approach on debt relief efforts for African countries, within the relevant multilateral frameworks'. The EU could also use its financial instruments to support or participate in the Liquidity and Sustainability Facility proposed by Africa and the United Nations, mobilising its financial institutions and considering appropriate guarantees, blended finance and technical assistance support.

(3) And illicit financial flows

To help increase the fiscal space of developing countries and allow them to mobilise resources needed for a sustainable recovery, more international efforts should also be devoted to tackle illicit financial flows (IFF). A recent report by UNCTAD estimates that the African continent loses an average of US$88.6 billion each year due to IFF, the bulk of it related to extractive commodities (UNCTAD, 2020). Improving domestic and international financial governance, including advanced economies as the main recipients of these IFFs, can do a great deal to compensate for some of the decline in foreign direct investment in 2020, estimated to range between US$10-US$20 billion below the level of US$45 billion reached in Africa in 2019.

The fight against IFF and tax evasion is part of the EU's agenda, in particular with Africa in accordance with their strategic partnership and with EU support to help Africa. But the EU lacks a more ambitious agenda on tackling IFF, with more specific action plans both globally and with developing countries.

More broadly, the EU's institutions and member states need to build on their commitment to work better together, under the 'Team Europe' approach, to outline in a more transparent way the specific actions they already –or want to– undertake to address macro-economic issues, including debt, IFF and financial governance, which could contribute to a more sustainable COVID-19 recovery.

(4) Financial institutions for development to leverage sustainable finance to build back better

As public resources are highly constrained, even in donor countries, to address the socio-economic consequences of the COVID-19 crisis it is more imperative than before for public actors to find more effective ways to mobilise sustainable private finance at scale. This is critical in the short term to limit the fall in private investment in developing countries. It is also essential to ensure that investment effectively contributes to a more sustainable, green, inclusive and gender-sensitive recovery, building back better. More focused attention should be given to the private sector and, in particular, micro, small and medium sized enterprises (MSMEs) –also in the informal sector–, which are the backbone of the economy and main job providers (Bilal *et al*., 2020b; Bilal *et al*., 2020c; UNECA, 2020a).

Financial institutions for development, at the international and domestic level, have an important role to play in that respect. They can accompany national public strategies for development in response to the COVID-19 crisis and help bring back confidence to more risk-averse domestic and international investors.

International financial institutions (IFIs) and development finance institutions (DFIs) have overall responded speedily and effectively to the COVID-19 crisis. In general, they have relied on their experience and leveraging capacity to adjust, reallocate and frontload their investments, helping their existing clients –who faced not only higher liquidity constraints but increasingly greater solvency risks– and reaching out to new opportunities and clients. IFIs and DFIs have also simplified and fast-tracked their internal procedures to allow timely responses and a faster fund disbursement.

But IFIs and DFIs are also faced with their own constraints to operate in a riskier and more uncertain environment as a result of the protracted COVID-19 crisis. Their high credit rating standards and conservative mandate reduce their agility to respond in a more countercyclical and more impactful manner over time. Ambitious and innovative approaches and instruments must be deployed to allow them to unleash their potential for a more transformative, sustainable and impactful leveraging of private finance at scale (Bilal *et al*., 2020a). In particular, IFIs and DFIs should be:

- Empowered to undertake more concessional and blended finance.
- Provided with more guarantees, for themselves and their clients, to increase their risk-bearing capacity for a greater impact.
- Encouraged to undertake more equity financing, with a tolerance for lower risk-returns, for greater sustainable impact.
- Allowed to make a more efficient use of their balance sheet with their existing capital and be granted more capital endowment if needed.
- Encouraged to cooperate more among financiers for development when appropriate towards co-investment, as well as with traditional donors and local actors, so as to better harness their sustainable investment potential to transformative endeavours.

In doing so, it is necessary that IFIs and DFIs commit to higher developmental standards and principles, notably regarding the Paris alignment and green finance, for climate mitigation but also climate adaptation and biodiversity (Ahairwe & Bilal, 2019), as well as with a gender-lens approach, adopting, for instance, the 2X Challenge principles (Ahairwe & Bilal, 2020). They should also pay much greater attention to inclusive investment opportunities so as to more effectively contribute to address the rising inequality resulting from the COVID-19 crisis, notably in poorer countries.

(5) From transaction to transformation, with local actors

To become truly more impactful, financial institutions for development should look beyond individual deals, towards more transformative approaches for their operations, emphasising not only the direct impact of each transaction, but also the developmental additionality of their activities and their systemic impact (Bilal, 2019). The European Bank for Reconstruction and Development (EBRD), with its transition qualities, has developed an appealing framework to select and guide its operations.

But to become truly more transformative, IFIs and DFIs need to connect to other actors, from private and civil society actors to public authorities and institutions, at both local and international levels, to identify complementarities, synergies and collaborative endeavours. In doing so, they can embed their operations in broader endeavours, as well as benefit from the insights, actions and dynamics of other actors (Bilal & Preston, 2019).

In practical terms, IFIs and DFIs can support local development initiatives by actively engaging in or joining local stakeholder consultations, making dedicated efforts to increase their understanding of local circumstances to better tailor their interventions, promoting country ownership by getting the buy-in of local actors (public and private) and improving their communication with local actors. Local presence, either directly or via partnerships and cooperative efforts with other actors present at the local level, is also a critical condition to better anchor their operations in local realities. IFIs and DFIs can also seek to ensure the consistency of their operations with other local and international initiatives, such as those aimed at developing hard and soft local infrastructures, or contribute to develop local financial markets, through private finance and local initiatives, and promoting local currency financing. Their operations can also help trigger or carry out efforts towards domestic reforms to promote a sounder enabling environment.

The EU and its financial institutions are well placed to adopt such transformative, cooperative and impactful approaches. The European External Investment Plan (EIP) is based on a three-pillar approach, combining European blended finance and guarantees for IFIs and DFIs (pillar 1), grant support, notably for technical assistance (pillar 2) and the promotion of an enabling environment and conducive investment climate (pillar 3). Under the new long-term budget of the EU for 2021-27, the EU has adjusted its instruments and financial framework to harness this comprehensive approach in its Neighbourhood, Development and International Cooperation Instrument (NDICI). This includes an open European mechanism for blended finance and guarantee, with the enhanced European Fund for Sustainable Development (EFSD+) and External Action Guarantee (EAG). The steering principles are meant to provide greater flexibility in EU development finance, to better respond to evolving needs while ensuring greater coherence in the EU, following a 'policy first' approach based on EU priorities for its external action. By adopting a 'Team Europe' approach, designed in the context of the EU's global response to the COVID-19 crisis, the Union also aims at enhancing the coordination between EU institutions and member states, as well as increasing the visibility of EU action (Jones *et al*., 2020; Bilal, 2020).

Specifically, this means that the EU is seeking to enhance the coordination between European financial institutions, notably the European Investment Bank (EIB), the EBRD and the financial institutions for the development of EU member states. It also aims to provide a better steering policy for investment carried out under the NDICI, and notably in the identification of flagship 'Team Europe' projects in developing countries. By working more closely with the European Commission, EU delegations in developing countries and European donors, the European IFIs and DFIs could also better build upon the policy and development activities of these European actors in developing countries.

While greater European coherence and synergy is a most welcome outcome in the 'Working better together' agenda, it should be carried out in close cooperation with other international actors, notably multilateral development banks and institutions and the UN, even more so in the context of the COVID-19 global response. Even more importantly, it must build on local needs, priorities and dynamics, together with local actors. This is what the EU is doing or should be doing. But there is always the danger that European actors become too focused on their own internal priorities, mechanisms and cooperation agendas, at the expense of coordination and engagement with local actors and locally owned initiatives.

Fortunately, there are many good practices and examples to emulate, build upon and scale up. In the context of the EU's global response to COVID-19, the EIB has notably engaged with local financial institutions to better address pressing needs. This is the case, for instance, with the Eastern and Southern Africa Trade and Development Bank (TDB) in supporting an SME and climate action facility. Building on local initiatives, Europe can be a powerful partner. This is well illustrated by the EIB's contribution in the form of a €75 million concessional loan to the Economic and Social Resilience Programme established by Senegal –a financing mechanism of over €300 million, to support the Senegalese private sector–, a cooperation initiative flagged under the Team Europe COVID-19 response. In this example, European support does not substitute for the local response, or lack of it, but instead contributes to enhance locally owned initiatives in a true partnership approach.

Similarly, European financial institutions partner with and contribute to enhance the capacity of local public financial institutions. This is the case, for instance, of the German KfW Development Bank and its participation in the establishment of the new development bank in Tunisia, the Banque des regions (BdR) –the Bank of Regions–. The BdR, set up by the Tunisian government, aims to provide access to finance and support for MSMEs in the various Tunisian regions, a segment of the market that is underfinanced, notably due to the weak performance of current public institutions, which will be absorbed by the BdR. KfW provides technical assistance, including knowledge transfer and support for the establishment of strong governance structures and principles (independently from the state). KfW will then provide a substantial line of credit to the BdR. By doing so, KfW contributes not only to the financing of MSMEs in Tunisia through its credit lines, an activity common to many DFIs, but also helps to create a stronger public financial institution, with a sound governance structure and operational practices, therefore also enhancing the credibility and sustainability of the BdR for a longer-term impact.

Conclusion

Towards Team Europe-African approaches

The Team Europe approach is proving an attractive rallying call for greater European policy coherence, which could usefully be implemented on the ground for European financial institutions of development. But to be truly effective, it must be anchored in local realities, with local actors and based on local priorities. Europe is well placed to do so, based on its experience and vast array of initiatives.

In the context of its strategic partnership with Africa, the EU should consider building strong alliances with local actors around a sustainable, green, gender-sensitive and inclusive investment agenda. This is even more important in the context of the harsh socio-economic consequences of the COVID-19 crisis, which call for a mobilisation of all resources available by a broad range of actors. Europe and Africa could do so by jointly adopting a Team Europe-Africa approach at the continental level for its overall framework, which could be articulated at sub-regional and country levels as appropriate and necessary. It could help bring together European and African financial institutions for development, prioritise and coordinate their actions to promote and mobilise sustainable investments to build back better in the recovery process of the COVID-19 crisis, in line with the sustainable development goals. Such endeavours could also facilitate the interaction with public authorities and donors, framing investment in more inclusive processes.

It is only through truly collaborative efforts towards comprehensive approaches for addressing the COVID-19 crisis that quality investment can be mobilised effectively to help a more inclusive and transformative recovery.

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